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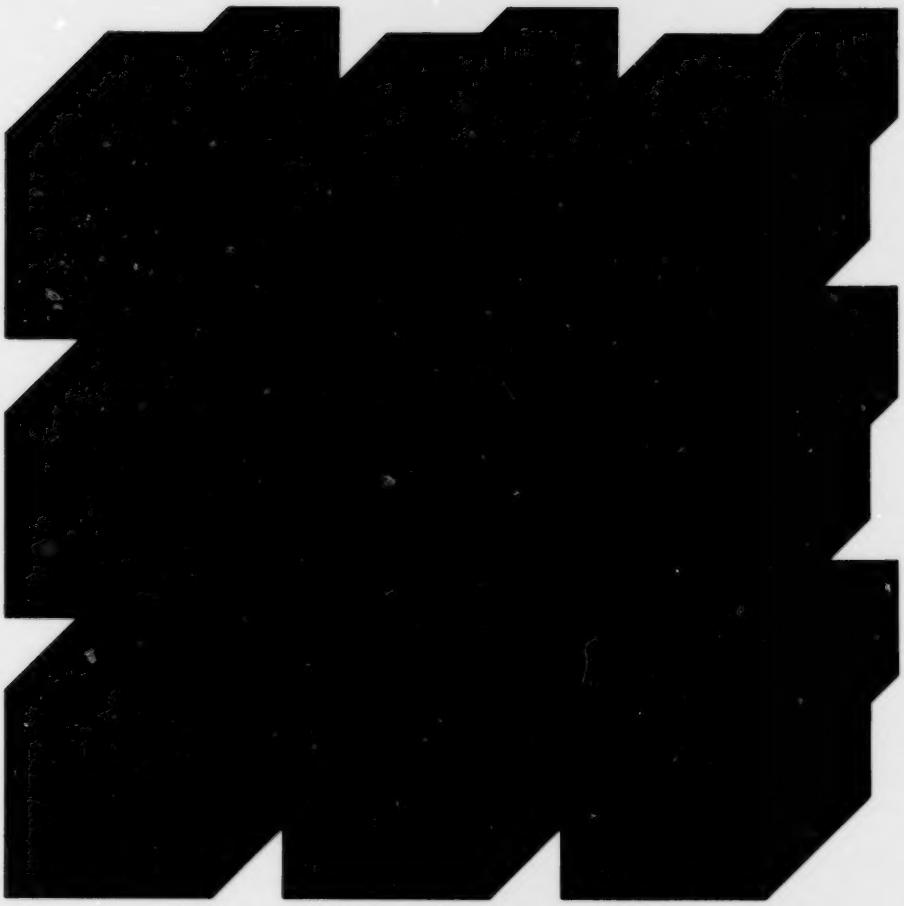

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DISCUSSION PAPER NO. 290

# Political Economy of Tax Reform: Six Case Studies

by Douglas G. Hartle

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# RÉSUMÉ

Ce document comporte six études de cas examinés à l'aide d'un cadre de choix publics établi au départ. Chacune de ces études examine une "réforme" fiscale particulière (terme non dépourvu de valeur normative). Les propositions de changement fiscaux examinés sont les suivants :

1) Abolitions des impôts fédéraux sur le décès et adoption d'un impôt sur les gains de capital (vers 1967-1972).

2) Ajustement de l'impôt foncier d'après la valeur courante du marché en Ontario (vers 1967-1978).

3) Intégration des impôts sur le revenu des particuliers et des sociétés (vers 1967-1972).

4) Introduction d'une indexation partielle de l'impôt sur le revenu des particuliers (vers 1972-1974).

5) Traitement de la composante inflationnaire des pertes et gains de capital (vers 1982-1983).

6) Transformation de la taxe de vente fédérale imposée aux manufacturiers en une taxe de vente imposée au niveau du marché de gros (vers 1955-1982).

Les propositions de réforme de l'impôt foncier se confinaient à la province de l'Ontario. Les autres s'adressaient surtout au gouvernement fédéral. Sans exception, toutefois, elles avaient toutes des implications pour les gouvernements provinciaux qui, au moins dans certains cas, étaient des intervenants actifs.

Les changements de structure de l'impôt, comme tout autre changement de politiques, peuvent être analysés à partir des résultats de certains ensembles de joutes continues auxquelles se livrent politiciens, bureaucrates, représentants de groupes de pression et représentants des médias. Chacune de ces joutes possède ses règles uniques d'entrée, de sortie, de jeu et de rétributions. Bien que les joueurs possèdent différents talents héréditaires et acquis, ils ont tous en commun la poursuite de l'intérêt personnel.

Ce dernier exige cependant différentes initiatives selon les joutes. Les politiciens recherchent l'élection et la réélection, les bureaucrates tendent vers des nominations et de l'avancement à des postes de plus grande influence, les représentants de groupes de pression veulent paraître efficaces du point de vue de la promotion des intérêts de leur groupe, et les représentants des masses média recherchent de plus vastes auditoires. Le succès de chacun, dans une joute donnée, dépend de ses transactions avec les autres joueurs dans sa propre joute, ainsi qu'avec les joueurs des autres joutes. Ces interactions constituent un cadre modifié et partiellement intégré de choix publics.

Les joutes prennent place dans des milieux économiques et institutionnels ("constitutionnels") qui imposent leurs contraintes au jeu. Deux autres catégories de contraintes s'ajoutent également : l'une consisterait dans les goûts variés et les préférences de l'électorat, et l'autre, dans les idées courantes qui structurent les perceptions de l'électorat et des joueurs.

L'électorat obtient la plus grande partie de son information sur la prise des décisions politiques par les médias. Comme organismes à but lucratif, les médias tentent d'obtenir le plus vaste auditoire possible. Ils y

parviennent en acceptant les pratiques habituelles adoptées par les voteurs individuels pour le choix de leurs informations : sauf lorsque les intérêts personnels sont immédiatement et directement affectés, ignorer les aspects et procédures techniques, abstraits, complexes et étendus. N'investir que dans la compréhension, lorsque le rendement attendu semble en valoir le coût. En conséquence, les voteurs sont mal informés sur les coûts indirects, largement répartis par des instrumentalités compliquées, et qui sont des coûts d'avantages accordés à des intérêts restreints, organisés et bien informés.

Il s'agit de groupes d'intérêt plutôt structurés que latents; en effet, étant peu nombreux, leurs communications ne coûtent par cher et se font en toute liberté, ils sont à l'abri des contraintes sociales et ils peuvent assurer des compensations tangibles à leurs membres cotisants. Certaines de ces organisations poursuivent des fins autres que le lobbying, comme les associations juridiques et médicales dont les fonctions consistent à accorder des licences. Pour ce genre d'organisation, les coûts marginaux de lobbying sont extrêmement faibles. Les organisations de lobbying peuvent être considérées comme des véhicules, pour leurs membres, d'investissement collectif dans des activités politiques

devant assurer des décisions qui leur sont favorables (ou éviter des décisions défavorables) au plan de politiques publiques collectives. En fournissant aux partis politiques ou aux candidats les moyens de mener leurs luttes électorales, ou en modifiant la perception des électeurs sur des questions d'ordre politique, ils se donnent la chance de faire tourner les décisions à leur avantage.

Les six propositions de réforme sont examinées selon cette perspective fondamentale plutôt qu'en fonction de la dichotomie habituelle efficence-équité de l'analyse économique. Ces idées qui mettent l'accent sur le rôle du gouvernement en tant qu'instrument de correction des imperfections du marché, et comme instrument de redistribution du revenu et de la richesse en vue d'une augmentation de l'égalité, ont certainement fait partie de l'environnement intellectuel ou normatif. Comme telles, ces idées ont été utilisées pour rationaliser certaines positions politiques qui, autrement, auraient été défendues pour d'autres raisons. Comme il est démontré dans les études, ces idées peuvent en effet avoir influé sur les politiques, surtout lorsque le jeu d'influence des représentants officiels pouvait s'exercer avec force.

Bien que les études de cas soient fondées sur une recherche raisonnablement poussée de la documentation publiée dans ce domaine, les ressources disponibles n'ont permis ni entrevues avec les principaux intervenants, ni analyse en profondeur du contenu des médias. Pour ce qui concerne le cadre conceptuel adopté, cette dernière faiblesse est grave, car il est alors difficile de vérifier les hypothèses avec une certaine rigueur. Le secret qui entoure le processus décisionnel, particulièrement dans le système parlementaire, fait du manque d'entrevues une limite également importante. Les archives ne sont qu'une fenêtre imparfaite sur le monde de la réforme fiscale.

Voici un résumé des conclusions les plus importantes des six études de cas.

1) Le cadre conceptuel adopté laisse présumer que les groupes de pression feront tourner les résultats des politiques à leur avantage. Cette présomption n'est pas contredite par les données rapportées dans les études de cas. Il existe néanmoins des cas notoires où les groupes d'intérêt ne se sont apparemment pas formés, où des organisations existantes ne sont pas intervenues comme on aurait pu s'y attendre.

2) Il existe amplement de données pour montrer que les gains d'efficacité présentent de nombreuses caractéristiques des biens publics : étant donné, en particulier, que ceux qui ne payent pas les coûts ne peuvent pas être exclus des avantages, ils ne se trouvent pas suffisamment assurés par la concurrence du marché économique ou celle du marché politique. Dans les cas où l'efficience politique et l'efficience économique étaient en conflit, la première en sortait toujours gagnante.

3) Lorsque la question de politique est hautement technique, les fonctionnaires nommés exercent - nul n'en sera étonné - une plus grande influence. Ils semblent s'être servis de cette influence, au moins en certains cas, pour faire valoir des considérations d'efficacité ou d'équité qui, autrement, auraient été négligées.

4) La recherche d'influence politique et les pressions visant à détourner les blâmes d'ordre politique se manifestent non seulement par la concurrence entre les partis politiques, mais également par la concurrence intergouvernementale dans le domaine de la réforme fiscale. Des politiciens de niveau municipal, dans un cas, et des politiciens de niveau provincial dans un autre, ont réussi à empêcher des réformes qui leur auraient été préjudiciables

sur le plan politique. Les politiciens eux-mêmes constituent des groupes d'intérêt fortement organisés.

5) Des conflits interpersonnels graves, au sein d'un ministère, semblent avoir joué de façon importante, au moins dans un cas, en faveur d'une réforme capitale. Présumément, des raisons "mauvaises" ont donné lieu à une "bonne" mesure.

6) Les injustices que comportent les changements fiscaux par une capitalisation du prix des actifs et le manque de mesures satisfaisantes de transition (comme l'accumulation de droits acquis) semblent s'être posées comme un barrière importante à certaines réformes.

7) La barrière la plus infranchissable pour la réforme fiscale se trouve peut-être, de façon globale, du côté des considérations "stratégiques". Certaines mesures, reconnues comme des améliorations en elles-mêmes et par elles-mêmes, sont rejetées sous prétexte qu'une fois adoptées, elles ouvriraient la voie à d'autres changements qui seraient dommageables. Par exemple, une assiette fiscale "plus équitable" permettant aux recettes de demeurer constantes prêterait flan à des augmentations subséquentes des taux, d'où l'opposition à une réforme de l'assiette.

## ABSTRACT

This paper consists of six case studies that are examined within a public choice framework sketched at the outset. Each of the studies considers a particular tax "reform" - a term not devoid of normative context. The tax change proposals considered are:

1) Abolition of federal death taxes and the introduction of a tax on capital gains (circa 1967-1972).
2) Adjustment of real property taxes to reflect current market valuation in Ontario (circa 1967-1978).
3) Integration of personal and corporate income taxes (circa 1967-1972).
4) Introduction of Partial Indexation of the Personal Income Tax (circa 1972-1974).
5) Treatment of the Inflationary Component of Capital Gains and Losses (circa 1982-1983).
6) Transformation of the Federal Manufacturers' Sales Tax into a sales tax levied at the wholesale level (circa 1955-1982).

The real property tax reform proposals were confined to the Province of Ontario. The others were primarily directed towards the federal government. Without exception, however, they had implications for provincial governments who were, at least in some instances, active players.

Tax structure changes, like other policy changes, can be analyzed on the outcome of existing sets of continuing games

involving politicians, bureaucrats, special interest group leaders and mass media journalists, respectively. Each game has its own unique rules of entry, exit, play and rewards. Although the players have different inherited and acquired endowments they have the pursuit of self interest in common. Self interest requires different actions in different games, however. Politicians seek election or re-election, bureaucrats seek appointments and promotions to offices of greater influence, leaders of lobby groups seek to appear effective in enhancing the interests of the group, mass media journalists seek a large following. Success in one's own game depends upon one's success in transactions with other players in your own game and with players in other games. This framework is a modified and partially integrated public choice framework.

The games take place within economic and institutional ("constitutional") environments that constrain the play. Two additional classes of constraints are also important: one might be called the varied tastes and preferences of the electorate, the other might be called the climate of ideas that structure the perceptions of the electorate and of the players.

The electorate obtains most of its information about the political decision making process through the mass media. As profit maximizing organizations, media enterprises try to reach the largest possible audiences. This is done by accepting the rules of thumb adopted by the individual voters in screening information: except where own interest(s) are immediately and directly affected, ignore the technical, the complex, the

protracted proceeding and the abstract. Invest in understanding only when the expected return is perceived to warrant the costs. Consequently, voters are ill-informed about indirect costs that are spread widely by sophisticated instrumentalities - costs that are incurred as a result of benefits provided to narrow, organized, informed interests.

These interests are organized rather than latent groups because the numbers are small, communications costs low and free-riding deterred by social pressures and/or by providing a tangible quid pro quo to paying members. Some such organizations exist for non-lobbying purposes, such as the licensing functions performed by legal and medical associations. For such organizations the marginal costs of lobbying are extremely low. Lobby organizations can be thought of as vehicles for the collective investment by the membership in political activities designed to secure favourable (avoid unfavourable) collective public policy decisions. By proving political parties or candidates with the means to fight elections, and/or by altering the perceptions of voters on policy issues, they obtain a capacity to influence political decisions to their own advantage.

The six reform proposals are examined from this basic perspective rather than from the usual efficiency/equity dichotomy of economic analysis. Those ideas that emphasized the role of government as an instrument for correcting market imperfections and as an instrument for redistributing income and wealth to increase the degree of equality were certainly part of the intellectual/normative environment. As such they were used

to rationalize certain policy stances that probably would have been undertaken for other reasons. These ideas may, indeed, have affected policy, primarily as guides to the exercise of influence by appointed officials when that influence was salient, as the studies suggest.

Although the case studies were based on a reasonably thorough search of published sources, available resources permitted neither interviews with the principal players nor extensive media content analysis. In terms of the conceptual framework adopted, the latter weakness is serious, in as much as it makes it difficult to test hypotheses with any rigor. The secrecy that surrounds the decision making process, particularly in a Parliamentary system, makes the lack of interviews an important limitation too. The public record is an imperfect window on the world of tax reform.

The most important findings drawn for the six case studies are briefly summarized below.

1) There is a presumption in the conceptual framework adopted that lobby groups will affect policy outcomes to their own advantage. This presumption is not rebutted by the evidence reported in the case studies. However, there are some notable instances where interests apparently did not organize or existing organizations did not act as might have been expected.

2) There is ample evidence to support the proposition that efficiency gains have many of the properties of public goods: in particular, because those who do not pay the cost can not be excluded from the benefits, they are inadequately provided by the

competition of the economic market or the political market. When political efficiency and economic efficiency were in conflict the former was always the victor.

3) When the policy issue is highly technical, appointed officials, not surprisingly, have more influence. They seem to have used that influence, at least in some instances, to advance efficiency/equity considerations that otherwise would have been neglected.

4) The search for political credit and the pressure to shift political blame manifest themselves not only in the competition between political parties but in intergovernmental competition in the area of tax reform. Municipal politicians in one instance and provincial politicians in another successfully blocked reforms that would have hurt them politically. Politicians themselves are strongly organized interest groups.

5) Internecene conflicts within a ministry seem, at least in one instance, to have been a major factor in securing an important reform. A "good" measure (presumably) introduced for all the "wrong" reasons.

6) The inequities involved in changing tax measures that have been capitalized in asset prices and the failure to provide adequate transitional measures (such as "grandfathering") seem to have been an important barrier to some reforms.

7) Perhaps the most intractable barrier to tax reform arises from what might loosely be called "strategic" considerations. Measures that are accepted as improvements, in and of themselves, are rejected on the grounds that if they were

in place they would facilitate other changes that would be damaging. For example, a "fairer" tax base, adopted on the basis that revenue would remain constant, is vulnerable to subsequent rate increases: therefore oppose the reform of the base.

# 1. INTRODUCTION

Many tax reforms are proposed but few are adopted, even in a modified form. An investigation would probably disclose that many of those eventually adopted have a relatively short half-life because they are later further modified or offset, in whole or in part. This study consists of the analysis, within a public choice framework that will also be sketched, of the apparent reasons why six specific tax change proposals met their particular fates - at least up to the present time.

These reform measures, numbered by section, are:

6. Abolition of death taxes and the introduction of the taxation of capital gains.
7. Adjustment of real property taxes to reflect current market valuation in Ontario.
8. Integration of personal and corporate income taxes.
9. Introduction of partial indexation of the personal income tax.
10. Treatment of the inflationary component of capital gains and losses.
11. Transformation of the federal manufacturers' sales tax into a sales tax levied at the wholesale level.

With the exception of item 2, all of the proposals were made by the Government of Canada although they had, with the exception of item 6, revenue implications for the provinces (except Quebec, which has a separate personal and corporate income tax structure).

Decisions take place within an intellectual environment: to use an older terminology there are competing ideas and beliefs that define "truth, goodness and beauty." These ideas and beliefs are brought into economic analysis as the preferences of individuals. These preferences specify the choices that individuals make within the feasible set of alternatives when faced with externally determined trade-offs between them. For the purposes of most analyses these preferences are taken as given. Investments in advertising and education, for example, can be conceived as changes in perceived relative prices (trade-offs) rather than as changes in preferences. If detergents A and B sell for the same dollar prices (have the same opportunity cost), and the long-time buyer of A "learns" that brand B gets clothes whiter than A, then the price of whitening clothes has fallen relatively. In the future, other things unchanged, more of A will be purchased by the buyer and less of B. By analogy, suppose it is widely accepted that marginal rates of tax that rise with income are ethically desirable as a manifestation of the golden rule: they achieve (it may be supposed) a greater redistribution of net benefits to the relatively disadvantaged than would otherwise take place. Suppose too that it is recognized that the "price" of this improvement in equity is a reduction in output by those "shirking" their responsibilities by working less because of the increasing tax rates. Should it become public belief/knowledge that a substantial proportion of those receiving a net benefit are really lazy rather than disadvantaged then the "price" of charity has risen. Less true

charity is being purchased for the lost output. Faced with a higher price, less support is forthcoming for the progressive rate schedule.

The "change in relative price" approach obviously does not broach the fundamental questions: why does the individual gain satisfaction from charity? Is it only self-interest that provides the motivation: buy out the potential revolutionaries? Or is charity (empathy) a learned want that seeks satisfaction too - the satisfaction of a clear conscience? These kinds of questions are not addressed by economics, per se. They are basic assumptions. Suffice it to say for present purposes that individuals' "wants" go beyond the physiological. At any point in time, they perceive budget constraints and the sets of prevailing prices involved in realizing them. The provision of "education", "advertising", "propaganda", "information", whatever the appropriate term, can alter these perceptions of prevailing relative price and thus alter individual choices.

In the relevant public finance literature it is usually assumed that there are widely shared beliefs that egalitarianism (redistribution), liberty (freedom of choice), fairness (equal treatment of equals), and material well-being (per capita real income) are desirable attributes (objectives) of a social/political system. The issue is not whether those attributes are desirable. Rather it is about the most effective way(s) of realizing them to a greater degree when they are not in conflict or about the magnitudes of cost(s) of realizing one in terms of the other(s) when they are.

The emphasis in this study is upon understanding the six tax reform attempts rather than upon assessing them in terms of these or any other normative standard. This is not to deny, however, that normative standards and the purported tradeoffs among them affected these reform attempts. Reform debates ostensibly at least, are about little else. Most public finance texts, aside from their description content, focus upon the neo-classical economic welfare consequences of alternative tax measures in a partial equilibrium, comparative statics, model. (The more recent sophisticated general equilibrium version is termed "optimal taxation" in the economics literature.[1]) That is to say, the feedback effects of changes in tax rates and structures are ignored and situations are compared at two discrete but ambiguously specified points in time. Economic welfare is defined in terms of Pareto optimality: economic welfare (individual well-being) is maximized when it is not possible to introduce a change that would make one or more persons better off, in terms of their individual preferences, after fully compensating for any losses. This approach generally takes the initially prevailing distribution of income/wealth as given. Whether or not the distribution of income/wealth should be changed is a non-economic matter that must be specified by some authority - preferably "benevolent". Egalitarianism (income/wealth redistribution) is usually accepted as a "legitimate" competing collective goal that can only be "purchased" by governments at a price in terms of foregone economic efficiency.

Under certain extremely stringent conditions (that no one assumes are fully met in the real world) perfect markets will yield a stable Pareto optimal outcome. When one or more of the assumed conditions is not met there is a potential role for government policy in correcting or compensating for the market imperfection(s). Moreover, government policies introduced for distributional reasons may distort the allocation of resources. Here too there is a potential role for corrective or offsetting policies. The world "potential" is emphasized because government intervention entails transactions costs (bargaining, contracting and enforcement costs) that also use up scarce resources. Only when the intervention corrects the imperfection and provides a gross benefit that exceeds the requisite compensation of the (almost invariable) losers and fully covers all transactions costs is economic efficiency unequivocally improved.

The most avid neo-classical economists, that is to say those with the greatest faith in the efficiency of prevailing competition and the existence of rational expectations in economic markets, will go so far as to argue that the status quo is invariably optimal. The argument is that private contracts are pursued up to the point where higher transactions costs would make them unprofitable. Therefore, by definition, the imperfections that remain can only be "remedied" at a cost that would exceed the benefit.

Economists of a less conservative persuasion or temperament (who coincidentally are almost invariably less sanguine about the prevailing distribution of income/wealth) believe that markets

are not always workably effective and individuals susceptible to persistently biased expectations. They therefore can rationalize some kinds of government intervention as market imperfection correcting. These arguments are not infrequently put forward by politicians to provide an economic justification for policies that, one suspects, are put forward for entirely different reasons. The most notable unspoken reason is the attempt to redistribute income/wealth in favour of groups of voters whose political support is being sought. This "real politique" view of the matter is, however, not the stuff of neo-classical welfare economics. Rather it is at the heart of public choice theory which seeks to apply the tools of economic analysis to assist in understanding non-market phenomena. As stated earlier, the case studies that are considered here are examined for this public choice perspective.

Whatever the merits of welfare economics per se, the prescriptions derived from it seem to have had little persuasive power with the public, and therefore with politicians, except as contrived rationalizations for measures adopted for other reasons, as noted. It is beyond the scope of this study to try to evaluate whether or not this benign neglect of the economists' normative injuntions is warranted. Suffice it to say, perhaps, that neo-classical economics would lead one to predict that economic efficiency improvement proposals would be largely ignored by politicians. The net benefits, if any, of market correcting measures have the same attributes as pure public goods: those who do not contribute to the political

investment required to bring about the requisite policy changes cannot be excluded from their enjoyment. Consequently, there will be a persistent underinvestment in securing economic efficiency generating "reform".

Another concept in taxation that played an important role in the reform debates of the 1969s and 1970s can be called, following Hettick and Winer, "equitable taxation". Equitable taxation involves two basic ideas: taxation should be in accordance with "ability to pay"; ability to pay is determined by the individuals' comprehensive income measured over the relevant accounting period. Taxing this base at a flat rate achieves horizontal equity. Vertical equity, on the other hand, involves the application of "appropriate" differences in tax rates (to be determined by politicians), to different levels of comprehensive incomes. Other relevant characteristics, such as the numbers of dependents and now discretionary medical expenses are also taken into consideration. Comprehensive income for the tax unit is defined as the change in net worth, plus consumption expenditures over the accounting period. To be more specific (and operational), comprehensive income includes not only labour and business income, interest, dividends, rent and royalties received. It also includes the change in the value of all marketable assets, whether traded or not, plus all gifts and bequests received over the period. With a few exceptions, such as the capitalized property tax, the comprehensive income tax would be the sole source of government revenue. Advocates argue that adoption of this base, with progressive rates established by

the political process, would result both in a fair and an egalitarian tax system that would allow the individual maximum freedom of choice.

It can be argued that such a broadly based tax achieves the maximum feasible degree of "neutrality", where neutrality means minimal distortion of the allocation of resources. While it is true that the choices between work and leisure may be distorted if workers are sensitive to changes in after tax wages, the same can be said about the choice between current consumption and saving (future consumption) if voters are sensitive to changes in after tax rates of return. The obvious alternative is a tax on consumption - comprehensive income minus the change in net worth. A tax on consumption avoids the tax discrimination against saving (ignoring the existence of bequests and their tax treatment) but cannot fail to discourage work if labour effort is sensitive to changes in after tax earnings. (This effect will be mitigated if leisure and consumption are inseparable.) Given that "consumption" would be measured as a residual (consumption equals income less saving) if it were to be taxed in lieu of income, there clearly would be no administrative or compliance cost in excluding savings from the tax base. What it would do, however, is focus attention on some of those parts of income that are currently ignored for one reason or another. One of the most important components in this context is the imputed value of owner occupied homes. It is not now included in the income tax base because it cannot be readily valued. Whether a consumption tax base that did not include such a major component of

consumption would be widely accepted remains to be seen. There are ways of coping with this problem but none is entirely satisfactory.

At the time that the reforms discussed in this paper were under consideration, there was little public debate concerning the merits of a consumption tax relative to a broadly based income tax. The battle, if such it was, was between narrowing the then existing tax base to exclude inflationary elements and broadening it to include capital gains.

## END NOTES

1. For a survey of the literature see Hettick and Winer, September, 1984.

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Hettick, Walter and Stanley Winer: "Blueprints and Pathways: the Shifting Pathways of Reform", Discussion Paper No. 268, Economic Council of Canada, Ottawa, September, 1984, p. 50.

## 2. BRIEF HISTORY OF RECENT MAJOR TAX REFORM IN CANADA

The fourth edition of the Concise Oxford Dictionary defines the word "reform" as follows: "Reform, v.t. 2 i. make ... institution, procedure ... become better by removal or abandonment of imperfections, faults or errors ..." Two attributes of this definition are noteworthy: because "better" is a normative term, what constitutes a "reform" as distinct from a "change" is in the mind of the beholder; "reform" seems to denote only the excision of that which is bad and only by implication its replacement by something that is better. It is not surprising, therefore, that advocates of tax changes, major or minor, almost invariably refer to them as tax reform proposals, sometimes leaving it to the audience to infer that their adoption would sweep away one or more burdensome features or undesirable consequence of the prevailing tax system - without drawing attention to the necessity of raising the same revenues by new or modified means. Nor is the demand for tax reform of recent origin. Schumpeter, writing of the evolution of the fiscal systems of the evolving nation states and Italian and German principalities, stated:

> We are accustomed to looking upon indirect taxation as contrary to the interests of the relatively poor. But in the seventeenth and eighteenth centuries the 'social' argument told in favour of indirect taxation: for indirect taxes were at least also borne by the nobility and the clergy whereas these classes contributed hardly anything at all to the proceeds of direct taxation. However, since it was not easy to introduce or reform indirect taxes either - which, by the way, shows how far those monarchies were from being 'absolute' - revenue from this source had to be increased according to opportunity rather than any rational plan. And since, furthermore, governments were rarely in a

> position to abandon revenue from old fiscal rights however irrational, burdensome, or vexatious the result was an almost unbelievable - the word is 'mess', the mere straightening out of which was an extremely difficult task which, when taken in hand in the seventeenth and eighteenth centuries, exercised the ingenuity of administrators and writers alike.[1]

While the references to the importance of political opportunism as a determinant of what was added and what was retained in the fiscal system seems remarkably contemporary, Schumpeter seems to have believed that the administrators and writers, by dint of great effort, cleared up the fiscal structure "mess" three or four hundred years ago. In point of fact, every fiscal system is widely perceived to be in a mess at any point of time: it either needs reform or is undergoing reform or is digesting a recent reform. Consider some recent history.

In the United States there was the Tax Reform Act of 1969 which was followed by the Tax Reform Act of 1976 which in turn was followed by Reagan's Economic Recovery Tax Act of 1981 (ERTA). Currently there is a recently revised set of sweeping proposals developed in 1976 by David F. Bradford and U.S. Treasury Tax Policy Staff entitled Blueprints for Basic Tax Reform. In the United Kingdom, there was the Report of the Royal Commission on the Taxation of Profits and Incomes that reported in 1955 and the Meade Committee Report of 1978 which is still actively debated.

The situation in Canada has been little different. The Royal Commission on Dominion Provincial Relations (Rowell-Sirois) was appointed in 1937 and reported in 1940. It proposed some fundamental tax reforms dealing with intergovernmental fiscal

relations. This was the first comprehensive review of the Canadian tax system. Some of the proposals, such as the exclusive assignment of certain taxes to one of the two levels of government are still being debated. Other proposals, such as the relief of the double taxation of corporate source income and the centralization of income tax structure decisions were later implemented, although not as a result of the Commission's work perhaps. In 1948, the Revised Income Tax Act was passed (effective, 1949). It incorporated and to a degree reconciled massive wartime income tax changes with the earlier system. This revision was sparked by and responded to criticisms made in extensive public hearings carried out by the Senate in 1945 and 1946. Among other things, the 1948 Act virtually eliminated any scope for ministerial discretion, established a Tax Appeal Board, adopted a new basis for depreciation (CCA) and introduced a 10 percent dividend tax credit (DTC).

> This revision, although a major forward step at the time, appears to have allayed the problems of direct taxation for only a decade. By the end of the fifties proposals were again being advanced for a comprehensive review. While "reform" seems to have centered on the direct taxes, there were rumblings of discontent over the federal sales tax as well.[2]

In response to these general rumblings, and in particular because of the consternation expressed by some tax practitioners about the problem of "surplus stripping - the tax treatment of distributions from the accumulated income of closely held corporations - Prime Minister Diefenbaker announced in September 1962, presumably in fulfillment of an earlier election promise, the appointment of a Royal Commission on Taxation to be chaired

by Kenneth Le M. Carter. After holding many hearings and having completed an extensive research program, the Commission's Report was submitted in December 1966, and released in February 1967. The proposals, if adopted, would have amounted to a massive realignment of the fiscal system. Among the measures proposed were the following:

- massive widening of the personal income tax base to include such items as capital gains, gifts and inheritances.
- adoption of the family as the basic tax unit.
- a top personal marginal rate of 50 percent.
- the corporate tax to be considered as a withholding tax for resident shareholders with full credit for corporate tax paid and an increase in the cost basis for shares to reflect retained earnings.
- replacement of the manufacturers' sales tax by a retail sales tax to be administered by the provinces together with their own sales taxes.

On the release of the Carter Report, the then Minister of Finance, Mitchell Sharp, called for comments on ten aspects of the proposals, to be in his hands by October. His Budget Speech of June 1967 strongly implied that a White Paper and a draft act would be tabled before the years' end.

The resignation of Prime Minister Lester B. Pearson, the Liberal leadership convention that chose Pierre Elliott Trudeau and the federal election of 1968 intervened. It was not until November 1969 that the then Finance Minister, Edgar Benson,

released the long-promised White Paper. "This was a very detailed document, and represented a considerable dilution of the commission's proposals", wrote Harvey Perry, a former Finance Department official, former Director of the Canadian Tax Foundation and former Royal Commissioner. (Background, p.81) He went on to state:

> However..with some exceptions, it did retain the principles of full taxation of capital gains; a full credit against dividends for the corporate tax (limited to 50 percent for widely held corporations); a flat rate corporate profits tax; less onerous changes in natural resource taxation but withdrawal of the three-year exemption for new mines. The comprehensive tax base was partially supported, with minor additions to income being made. Drastic simplifications were proposed for the personal income tax schedules and exceptions, but these were overdue in any event.[3]

There followed, after some false starts, separate public hearings by the House of Commons and the Senate during 1970. Reports were issued by the Senate's Standing Committee on Banking, Trade and Commerce and the House of Commons Committee on Finance, Trade and Economic Affairs in the Senate Report: Sept/70 - H of C Report: Oct/70.

The next crucial step was the tabling by Finance Minister Benson of an Appendix to the Budget Statement of June 1971. This Appendix contained Benson's draft of what he and his officials believed would be an acceptable compromise reflecting the work of the Parliamentary Committees, and the avalanche of submissions received by the Department arising from the White Paper. The result was a substantial retreat from the White Paper which was itself a substantial retreat from the Carter Report.

Bill C-259, to implement what remained of the reform proposals, was given first reading on June 30, 1971. After a

long House of Commons debate, further Senate Committee hearings and many amendments, the legislation finally passed both Houses to be effective at the beginning of 1972.

In the ensuing dozen years there has been a host of additional tax changes over and above the many "tidying-up" measures arising from the major revision of 1971. Most notable were the changes proposed by the Honourable John N. Turner in his Budget of February 19, 1973 and those proposed by the Honourable Allan MacEachen in his November 12, 1981 Budget.

In the former Budget Turner introduced a partial indexation of the personal income tax, and MacEachen proposed in the latter a large number of "reforms" including, among many others: "temporarily" capping the partial indexation, converting the manufacturers' sales tax (MST) into a sales tax at the wholesale level; repeal of the deduction for income averaging annuities; limiting the deductibility of investment costs; taxing accrued interest income every three years; more stringent taxation of employee benefits; and the reduction of CCA allowance to one half for the first year of asset acquisition.

Within a few weeks (December 18, 1981) MacEachen introduced many ameliorating changes of the proposed "reforms" in response to the public outcry occasioned by his November Budget. But these concessions did not go far enough, apparently. Further withdrawals were announced by MacEachen in his Budget of June 28, 1982. This turned out to be MacEachen's last Budget, for he was soon replaced by the Honourable Marc Lalonde who, in his Economic and Fiscal Statement of 27 October 1982, virtually completed the

rout of the MacEachen reforms but Lalonde did introduce temporary limits on the partial indexation of the personal tax system to 6 and 5 percent in 1983 and 1984, respectively. What remained of MacEachen's November 1981 Budget after Lalonde's October 1982 Budget, together with the de-indexation provisions were put into legislative form in Bill C-139 and became law on March 30, 1983. Among the MacEachen measures postponed by Lalonde was the introduction of the reforms of the federal manufacturers' sales tax.[4]

It must be emphasized that while MacEachen's now infamous November 1981 Budget has been dubbed a "reform" Budget, and indeed did propose many changes that were similar to or derivative of the Carter Report recommendations of fifteen years earlier, the overall thrust of the original proposals was to increase revenues - by $1.4 and $2.0 billion in 1982-83 and 1983-84 respectively, according to Gillespie.[5]

The reduction of one half of CCA in the year of acquistion of an asset, the broadening of the personal income tax base by the elimination of some preferences (in particular the withdrawal

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* For detailed summary of the original (November, 1981) proposals and the two subsequent sets of total or partial withdrawals in the June 1982 and October 1982 Budgets see the Tables appended to Irwin Gillespie's: "The 1981 Federal Budget: Muddling Through or Purposeful Tax Reform", Canadian Tax Journal, (Nov.-Dec. 1983) Vol. 31, No. 6, pp. 989-1001.

of the income averaging annuities) and some corporate tax changes, would have raised more revenues than the proposed reduction in marginal tax rates for individuals would have reduced them. Even after all the subsequent "grandfathering", the adoption of general transitional measures, the postponements and abandonments of the November 1981 proposals, Gillespie estimated that the 1983-84 original revenue increase of about $2.0 billion was only reduced by about 25 percent to $542 million.[6] In addition, the "temporary" capping of the personal income tax partial indexation introduced with the ? 1982 were designed to increase revenues during 1983 and 1984 by $1.3 billion.[7] The severe difficulties encountered by the Government in attempting the 1981 "reforms" therefore were not only a matter of the resistance of potential losers overwhelming the support of the potential winners under a constant revenue package of structural changes.

By attempting to substantially raise additional revenues in the course of the reform the number of potential winners and/or the magnitude of their winnings was substantially reduced; and conversely for the potential losers. In the real world it is seldom possible to find examples of actual tax structure changes that are neutral, on balance, from a net revenue point of view. The success or failure of such proposals, even when advanced on a constant revenue basis, can, therefore, seldom be judged in isolation from expectations concerning accommodating or inhibiting revenue changes. The same can be said of other factors that affect the degree of support and opposition to

structural change proposals: the perceived economic outlook, the degree of political instability prevailing at the time, the prior changes in the tax system and in other policy instruments - to name only a few of the obvious determinants.

Despite all of the turmoil surrounding the MacEachen Budget and its aftermath, the demand for further tax reform is not dead in Canada. Two examples will perhaps serve to make the point. Ronald Anderson, the "Report on Business" columnist for the Globe and Mail, wrote an article published February 3, 1984 entitled: "Tax System Discourages Enterprises and Excellence".[8] The thrust of the article is that the existing Canadian tax system "... discourages extra effort, penalizes excellence and fosters dull conformity" when it should reward effort, stimulate entrepreneurial risk taking and promote adaptation to change. This could be accomplished, according to Anderson, by implementing changes along the lines proposed in a speech by John Evans, Liberal M.P., then Parliamentary Secretary to the President of the Privy Council. The Evans tax reform proposals had been favourably reviewed by Donald Huggett, the national tax partner of Coopers and Lybrand, chartered accountants (Huggett was a one-time contract employee of the Department of Finance in the late 1960's and early 1970's working under the direction of James Brown of Peat, Marwick, Mitchell and Co., who was the senior Departmental advisor on the Carter Report - White Paper - Benson proposals). Huggett said of the Evan's plan that it represented "a simple and workable plan that deserves careful study ... (and) ought to find adherents from all sectors of

society." Huggett thought so highly of the Evans proposals that he reproduced Evans' speech in its entirity in the firm's Canadian Tax News (December, 1983 issue). The Evans proposals are similar to one of the plans put forward by the U.S. Treasury in the recently revised Blueprints for Basic Tax Reforms originally published in 1976. In essence, they would entail a top combined federal-provincial marginal personal tax rate of 30 percent (down 20 points from the existing system); full integration of the personal and corporate income taxes (rather than the partial integration obtained through the dividend tax credit) and the transformation of the personal income base tax to a consumption base tax rather than the generous but limited deductions for certain kinds of retirement savings as at present.

More recently still, all three federal party leaders in the campaign leading up the 4 September 1984 election, sympathized with the demand for changes that would "get tax-bites more in line with incomes" in Toronto Star columnist Jack McArthur's phrase. Not surprisingly, the New Democratic Party hit this issue the hardest.

The essence of the leaders' criticism of the current system, which was of course shared by the columnist, is that because of the myriad concessions, many upper and upper-middle income individuals now pay little if any tax. This thwarts the realization of the "sacred principle", also using McArthur's terminology, that the "more money you make, the more income tax you pay". (Note that "more" is not specified as more absolutely or more relatively!) Broadbent of the NDP has advocated a

minimum tax of 20 percent on incomes higher than $50,000. Turner and Mulroney were less specific in their promises as befitted potential future Prime Ministers.

Most of McArthur's column was devoted to providing data on the number of taxpayers with relatively high incomes who pay little or no tax and, more important for the present purpose, indicating why a reform of the current "loopholes" in the Canadian tax system is so difficult for any political party in power. McArthur pointed out that there are only about 55,000 returns from individuals with declared incomes in excess of $100,000. The barrier to specific tax reform, in his opinion, lies with the 1.3 million taxpayers (voters) in the $30-$50,000 a year income range.

> They also happen to be a highly money-and-tax conscious bunch. They vote in large numbers and tend to be active talkers and participants when it comes to issues important to them ... These relatively influential people would be super alert once you began to actually reshape the writeoffs they use or hope to use (my emphasis) ... And once tax reform begins who knows where it might go? What other bits of the system might be found unfair? Changing one or a few items can lead to a domino-like change for others that are related by reason of equity or practicality ... Past attempts at reform have shown that. The result tends to be mushrooming opposition, based more on vague fears than hard-headed calculations."[9]

These references to the most recent (at time of writing) tax reform proposals and the columnist's comments on the difficulties of bringing about tax reforms provide a fitting ending to this general historical Section of this paper.

In the next Section, the main features of a public choice framework for analysis are briefly set forth.

## END NOTES

1. Schumpeter, History of Economic Analysis, p. 201.
2. Perry, J. Harvey, Background of Current Fiscal Problems, p. 78.
3. Ibid., p. 81.
4. For a detailed list of the original MacEachen proposals and their respective fates, see Irwin Gillespie, CTJ, 1983, pp. 989-1001.
5. Ibid., p. 1000.
6. Ibid., p. 983, fn. 22.
7. Ibid., p. 983.
8. Anderson, Globe and Mail, February 3, 1984, p. 84.
9. McArthur, Toronto Star, p. 31.

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# 3. A PUBLIC CHOICE APPROACH TO POLICY MAKING[1]

Governments should seek to reduce or offset economic inefficiency when it is inherent in imperfect markets or is an unintended side-effect of one or more other government policies. They should adopt the means of realizing redistribution objectives that have the least untoward affects on economic efficiency. These are the normative positions of conventional economics, as stated earlier. Ignored are the actual incentives under which public policy makers, and others involved in the public policy making process, actually function. This is anomalous given that the whole conception of market efficiency rests on the assumption that self interest is pursued by consumers on the one hand and competing suppliers of goods and services on the other. It is even more anomalous when one realizes that greater economic efficiency provides a collective benefit - a greater output of the goods and services people want relative to what they (hypothetically) otherwise would have - that cannot be captured exclusively by individuals or groups involved in the decisions that determine its size. Indeed,conventional economics treats the collective decision making process as though it were internalized in the mind of some kind of all-knowing, benevolent disembodied entity as reflected in a mathematical expression called a Social Welfare Function. This entity somehow or other aggregates the preference of the citizenry and makes the "appropriate" trade-offs where necessary. None of this is satisfactory when it comes to analyzing concrete policy issues such as tax reform.

Considering those individuals involved in public policy decision making as self-seeking players in sets of interrelated "games" is an alternative approach that appears to be more consistent with the basic assumptions and methodology of most economics. The term "game" is used to denote that each of the several games (political, bureaucratic, lobbying and media) has its own set of unique rules including rules of entry and exit, rules of play and rules of reward and punishment. "Game" also seems the appropriate term because decisions are made in the face of ubiquitous uncertainty concerning the reactions of others to each player's initiatives.

Attributes of Voters

Although the players in the four differentiated games are usually voters, it is the vast majority of voters who are not active players in policy decision making games with whom we must also be concerned. The pursuit of individual self interest can be assumed to apply to the political activities of individuals in the same way as it does to their economic activities. Most of the decisions of government officials, whether elected or non-elected, can affect, actually or potentially and positively or negatively, the interests of resident individuals. These interests can be thought of as bundles of rights to such diverse things as: real and personal property; personal health and reputation; skills; tenure of offices and employments; entitlements to public and private transfer payments; tax liabilities (a negative right); and access to transportation

communications, legal and other systems. The bundle of rights (less obligations) will, for want of a better name, be called an individual's Comprehensive Net Worth (CNW). The object for the individual is to maximize own his (or her) CNW within the constraints of his resources, maintenance (subsistence) requirements and the prevailing behavioural rules. Political activities can be thought of as investments made in the expectation of, in the first instance, maintaining existing rights holdings and, in the second instance, expanding those rights. Political investments take two forms: informed voting and what can be called lobbying. Lobbying can be formal or informal: it can be carried out by individuals or collectively through organized groups.

Far from being all-knowing and all wise, individuals are called upon to make decisions for which they are ill-informed and are often biased in interpreting the facts. With limited intellectual endowments for genetic reasons, with only limited time, effort and resources to devote to learning, all individuals have gaps in their understanding. It might be expected, however, that the individual's attempts at understanding will be focused largely on those areas of knowledge that encompass the perceived determinants of their CNW. (Note that these determinants can differ dramatically from individual to individual.) Thus, for example, an individual would be relatively well informed about his own occupation or profession, his own accommodation, his own portfolio of financial assets and his own taxes and entitlements. Changes that do not affect or are thought not to affect an

individual's CNW are frequently ignored by him or her if they are perceived at all.

As a means of reducing information and decision costs, rules of thumb are adopted and symbols used to signal vague, complex beliefs and attitudes.

Politicians

It is in the interest of politicians, indeed it is their proximate objective, to be elected (or re-elected) as a member of a government in power and to obtain positions of ever-increasing power and authority in that government. Under the parliamentary system this involves, after being nominated, winning a plurality of votes in a constituency for the party that wins a plurality of constituencies. Such a party plurality will usually mean that the party forms the government even without a majority of seats. When it holds a majority of the constituencies the party will form the government for a length of time to be determined, within a fixed limit, by the leader of the party because party discipline is usually strong and virtually precludes defections.

In casting their ballots voters will choose from among the candidates, parties or leaders the one that is expected to put policies in place that will provide them with the greatest net benefit (or least net cost) relative to the alternatives. Greatest net benefit means the largest expected stream of net benefits (satisfaction) derived from the individual's present and future holding of rights (CNW).

The labels of political parties and party leaders are often taken by voters to symbolize a bundle of prospective policy choices based perhaps on their perceived past performance records or perhaps on less tangible considerations. The personal attributes and campaigning of particular candidates, other than the party leader, seems to carry little weight in the decisions of voters.

In order to maximize his likelihood of election or re-election as a member of a winning party, a candidate must try to obtain the nomination of the party with the support of the highest proportion of decided voters in a constituency where such continuing support has been forthcoming for a sustained period - it being recognized that switching party allegiance by politicians is likely to be viewed with a jaundiced eye by the members of all parties and many voters. Having secured the desired nomination (no simple or inexpensive step in reality), the candidate must work both within the party and independently to secure the support of uncommitted voters, particularly in constituencies where there is now, and has been historically, a high proportion of uncommitted voters. These are the so-called swing or "marginal" seats - also known as ridings or constituencies.

To put the matter the other way round: parties, leaders and candidates increase their likelihood of success (obtaining the largest possible number of seats) by seeking to appeal to the uncommitted voters in marginal (swing) constituencies. Although voter commitment to a party is presumably a matter of degree and

can be shaken, there is less to be gained from trying to change the minds of those who have reached a decision than it is to convince those who are still undecided. At the extremes, rewarding the faithful is unnecessary and rewarding staunch opponents is futile.

What must be done by a politician or a party to secure the support of uncommitted voters without alienating committed supporters? The simple answer would be to offer to provide the uncommitted voters with benefits that would be at the expense of committed opponents and, if needs be, committed supporters. Committed supporters can be forced to "contribute" up to the point where their future benefits are perceived to be only slightly greater than the benefits that the opposing party would provide. An alternative would be to spread the costs so widely and hence thinly that they would be either overlooked or ignored because the organizational costs of fighting them would be greater than the stakes on an individual basis.

It must be borne in mind that in this context benefits and costs are reflected in the voters' expected future flows of satisfaction derived from the voters' possession of rights. Perceptions need not be "correct" to be valid in affecting voter choice. Politicians can generate inconsistent perceptions among different groups of voters because of their ignorance and biases. Many are ill-informed about complex matters, particularly those that are remote from their day to day experience, and view the evidence, such as it is, through distorted frames of reference. Thus, the promised shares of the pie are not necessarily constrained by the real size of the pie.

Lobby Groups

Casting a ballot for a candidate who is thought to be well disposed towards a decision that is favourable to a voter is only one of many ways of trying to obtain a desired public policy decision. Lobbying, which can be defined as an attempt to influence, in a direction favourable to the lobbyist, the decision(s) of a person(s) in authority, is a common occurrence in pluralistic societies. It is carried out by individuals and organized groups either directly or indirectly through the use of paid agents. Lobbying can involve as little as informing the decision maker about some relevant (often biased) "facts" that may have escaped the politician's attention. It can involve as much as mounting a major publicity campaign designed to convince tens of thousands of voters to support a particular candidate or party on a desired policy decision. Generally speaking, lobby groups enter into a kind of transaction with decision makers. Groups offer to supply (or threaten to withhold) something the policy maker wants, such as campaign funding, in exchange for a favourable decision(s). Because the interests of different groups of individuals are so often in conflict, there are usually competing groups vying for influence over particular decisions. There is no presumption that all of the relevant interests are represented proportionately. Some interests that are widely held may not be pursued by any organized group: other interests that are held by only a few individuals may be strongly represented.

Among the most important determinants of the formation and maintenance of an organized lobby group are the following:

- the average value of the issue at stake to the individuals who have a common interest.
- the size and geographic dispersion of these individuals which the cost of communicating with each other and the costs of exerting social and other pressures.
- the ability of the organization to provide some benefit, over and above the pursuit of the common interest through lobbying, as an added inducement to membership.
- the ability of the organization to minimize the number of individuals - "free riders" - who would share in the benefits provided by the organization but would not contribute their share of the costs if they could be avoided.

Although there are no doubt exceptions, the general rule is that, for a given aggregate common interest, the larger the number of individuals with common interest and the more dispersed the members geographically, the less likely is the formation of a continuing, effective lobby group organization. The reason is that organization costs rise dramatically as numbers rise because of the free rider problem. With small groups informal pressure can be brought to bear that reduces the proportion of free riders at little cost. This is not feasible with a large and dispersed group. An important exception is the organized groups that exist for some other non-purpose - such as medical and law societies and labour unions. Because membership in these organization is a prerequisite for professional practice or for holding some jobs, free riding is eliminated. In these circumstances the lobbying costs are but a small addition to the continuing operating costs incurred for other reasons.

Media

Voter perceptions, it has been emphasized, are the reality of public policy decision making. Those perceptions are greatly affected by the news coverage and its interpretation by the mass media and in particular newspapers and television. News reporting (entertainment reporting is ignored) is inherently a highly selective activity. Some news is not gathered because it is too costly to obtain or is not available to the public for a variety of reasons, or is not thought to be of sufficient interest to enough individuals to warrant the cost of collection, assembly and dissemination. Of the news that is gathered, the prominence assigned to it by the mass media is entirely discretionary as is its interpretation. To some degree, the prominence given to a news item constitutes a kind of interpretation: items given great prominence ispo facto have a kind of implicit importance assigned to them even though there is no explicit interpretation offered. But what are the criteria applied when assigning a news item "importance"?

The answer can be presumed to be primarily in journalists' and publishers' (terms used to apply to all of the key figures in the mass media) judgements concerning the size of the audience a news item will attract and the intensity of the attraction. Publishers are businessmen striving to maximize profits. Because revenues are obtained primarily through the sale of advertising, and advertising rates are determined principally by the size of the audience, audience appeal is crucial. Publishers will

therefore employ and promote those journalists who can deliver what the largest potential audience wants. Audience wants are determined primarily by the considerations mentioned earlier: readers and viewers most want to know about those events that are perceived to be likely to affect their interests directly, especially where there may be an opportunity to take some action that will further or protect or enhance those interests.

Some qualifications are in order. The more complex the appearance of the issue the less its appeal, other things being equal, because of the rational ignorance phenomena. The expected return on investments in knowing must exceed the costs of knowing. The more familiar the frame of reference (including the ideological component) in which the issue is couched, the greater its appeal, other things being equal, because of the cognative dissonance phenomena. People do not like to have their beliefs challenged.

These considerations bear upon the public policy decision making process in a crucial manner.

1. By giving prominence to a news item that, superficially at least, seems to be readily understandable, concerns an event that affects the interests of many individuals and is consistent with their prior beliefs (favourable or unfavourable prejudices) the mass media, particularly newspapers, can largely determine the agenda for the public policy debate. An example would be the attention given by the media to the question of tax concessions for business following David Lewis' coining of the phrase

"corporate welfare bums", as the spokesman for the NDP in the 1970's.

2. Governments can often times reward uncommitted voters in marginal ridings (at the expense of committed voters in intramarginal ridings) by public announcements that are clearly understood by the winners but ignored by the losers. This can be done by:

- increasing the complexity of the method of intervention so that it will be reported only in specialized publications with which the winners are familiar but the losers unfamiliar;
- Emphasizing the direct benefits while downplaying the indirect costs;
- Concentrating the benefits but spreading the costs with the result that the winners invest in knowing and organizing while it does not pay losers to become informed, much less organized, to fight.

The conceptual framework underlying the analysis of the six case studies that comprise this Discussion Paper can be summarized in the following simple matrix.

| TAX REFORM PROPOSALS | GAMES | | | | |
|---|---|---|---|---|---|
| | Ideas and Beliefs | Policical | Bureaucratic | Special Interest Groups | Media |
| 1) Abolition of death tax and introduction of capital gains tax | | | | | |
| 2) Introduction of market value assessment for Ontario property taxes | | | | | |
| 3) Integration of personal and corporate income taxes | | | | | |
| 4) Introduction of partial indexation of the personal income tax | | | | | |
| 5) Treatment of inflationary component of capital gains and losses | | | | | |
| 6) Transformation of manufacturers sales tax into a sales tax levied at wholesale level | | | | | |

In some of the studies, boxes are left virtually empty. This occurs because some of the games do not appear to have been

much involved in the reform conflict. It would be tedious to appear to be trying to systematically fill in a box even when it was really devoid of substance. The lack of information is also a factor. As emphasized earlier, conflict resolution is more often than not achieved behind closed doors. The public record does not reveal the "true" story in some instances. The lack of a thorough media content analysis must be acknowledged. Television coverage, that most important of mediums in terms of voter persuasion, is entirely missing.

Some of the features of the public choice approach that are especially pertinent to the question of tax reform should be emphasized.

1. The "rational actor" approach to decision making, that closely approximates the traditional economists' conception, focuses upon the realization of an objective(s) using policy means (instruments) in the most cost effective manner. This entails realization of the objective to the greatest degree consistent with a given cost constraint or incurring the least cost in realizing the objective to a predetermined extent. The legitimacy of the objective, whatever its source, is taken as given. In economic analyses the basic objectives are customarily related to employment, changes in the price level, economic growth, and "fairness" in the distribution of income and wealth. In public choice theory the proximate objectives are the self interests of the principal actors. For politicians this implies, as we have explained, that goals like full employment and zero

inflation are pursued, if at all, as means to electoral success not for their own sake.

Moreover, many of the interests of voters are not homogeneous. The aged, young adults, unionized industrial workers, beef producers, motorcycle owners, to name only a few groups, have some unique interests. Only some are organized and play a politically active lobbying role. Most are, as Olson describes it, "latent" groups. Promises of full employment, stable prices and rapid economic growth are not equally salient to all latent and organized groups. Obviously, the aged are more concerned about the achievement of stable prices then they are about the achievement of full employment; and conversely for young adults. Motorcycle owners and beef producers, per se, are more concerned about safety regulations and agricultural marketing boards, respectively, than about the "grand" economic objectives.

Competing political parties offer voters explicitly or implicitly alternative "bundles" of future policies. Each bundle has a number of characteristics and each characteristic is assigned a subjective (utility) weight by the voter. Other things being equal, the voter chooses the policy bundle with the greatest net utility value. Presumably, a voter would choose a party with a policy bundle that consisted of higher prospective taxes and even higher prospective income over a competing party that offered the converse. However, if all parties offer, with equal plausibility, to pursue all the grand economic objectives with equal vigour, differences in tax policies could become the decisive factor for some marginal voters.

To be politically efficient, the politician has to be highly selective in offering tax concessions. Preferably they should be restricted to those marginal voters for whom the tax saving is likely to be decisive - given great weight. Even if it is true that everyone has their price, the tax revenue foregone in securing the support of uncommitted single issue voters who give enormous weight to, say, policies regarding motorcycle helmet regulations or beef marketing boards, may be too high and cost the support of even more marginal voters who strongly oppose the higher taxes for themselves that would be entailed by the concession.

2. In conventional economics it is generally assumed that all individuals are fully informed on all relevant matters or that the median individual has completely rational (correct) expectations and the errors of the others are unbiased (e.g. cancel out). Public choice, at least the variant expounded here, envisages the investment of resources by some individuals and groups in an attempt to distort the perceptions of others to the investors' benefit. Thus, when it is to their advantage, politicians seek to minimize the perceived costs and maximize the perceived benefits of policies. Generally they seek to minimize the perceived costs of their own policies and the maximize perceived benefits; and conversely for the costs and benefits of the opponents.

To finance the investment in "perceptual alteration" politicians and political parties need real resources. These are

obtained, in one way or another, from interest groups in exchange for actual or potential advantages. In essence, organized groups of voters who are fully informed about their own interest(s), partly through the agency of political matters, provide misleading information to uninformed voters who are actual or potential losers, thereby reducing the opposition.

3. There is a wide range of instrumentalities available to politicians by which to confer benefits or impose costs. Expenditures, loans, loan guarantees, taxes, tax expenditures, borrowing, government ownership of enterprises and regulations are the principle types of policy instruments. Each has a multitude of variants. There is, therefore, literally an infinite number of alternative instruments available. In selecting the instrument the prime concern will be its "political efficiency". This term denotes the optimal effects on the likelihood of electoral success.

4. Taxes have certain attributes, other than the obvious burdens, that have to be taken into account in considering the issues raised by reform:

a) Tax statutes, like regulations, once on the books usually do not have to be examined again by legislators. Expenditures, under Parliamentary rules, have to be voted each year. Tax concessions, once obtained, therefore, are not subject to automatic, periodic review and hence are likely to be more secure.

b) Taxes leave dollar "tracks": the annual revenues raised. Tax concessions, on the other hand, leave no dollar tracks unless a special effort is made to estimate the revenue cost of tax expenditures - at best a periodic effort open to criticism concerning assumptions, data and methodology. This too helps to shield the benefits from attack. Tax concessions often involve complex and obscure provisions in the taxing statutes. Those who do not have a "need to know" are unlikely to make the investment involved in understanding them. This provides yet another shield.

c) Finally, because of their complexity, officials play a larger role in the design, interpretation and application of most tax concessions than is likely to be the case with simpler instrumentalities. The result is that the support or opposition of officials towards particular provisions, actual or proposed, is more important because their influence is correspondingly greater. Lobby groups are therefore likely to invest substantially in trying to influence these influential officials.

## END NOTES

1. For references see Hartle, "The Theory of Rent Seeking: Some Reflections", pp. 553-554.

## REFERENCES

Hartle, Douglas G., "The Theory of Rent Seeking: Some Reflections", Canadian Journal of Economics, (November 1983, XVI, No. 4, pp. 539-554.

## 4. DETERMINANTS OF THE POLITICALLY OPTIMAL MIX OF TAXES AND EXPENDITURES

To envisage some of the considerations involved in proposing tax or expenditure changes, suppose there were only two possible policy instruments: a poll tax and expenditures on a defence force providing homogeneous units of defence services that are equally available (if not of equal utility) to all. The tax revenue, it can further be assumed, must just finance the defence expenditures. Assume that the political benefits and costs, that can be denominated in terms of the number of seats (ridings) won and lost, respectively, can be determined for each level of defence services.

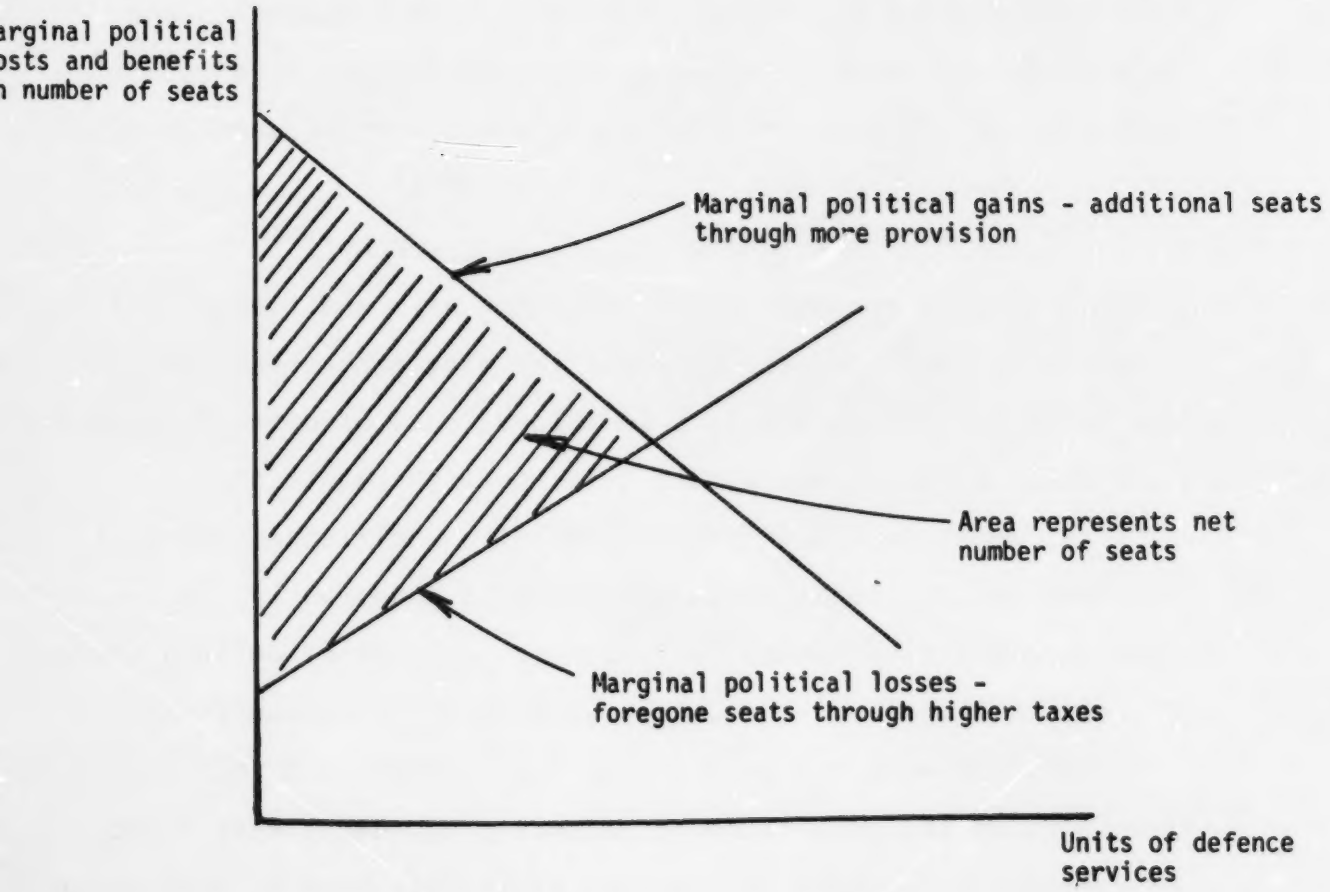
For the first few units of defence the benefits (seats gained) exceed the costs (seats lost) but with additional units the marginal benefits decline while the marginal costs rise. At some level of defence the last additional unit of defence creates additional political costs that just equal the additional political benefits. With still more units additional political costs exceed additional political benefits. Obviously, the optimal political strategy is to provide a level of defence where marginal political costs equal marginal political benefits.

If these were the only policy instruments, and the efficiency of tax collection or defence procurement were fixed, the competition between the parties would lead them to promise to provide the optimal number of defence units (as just defined).

**Diagram 1:**

**Optimal Provisionof Defence Services in**

**Terms of Parliamentary Seats**


arginal political
osts and benefits
n number of seats
Marginal political gains - additional seats through more provision
Area represents net number of seats
Marginal political losses - foregone seats through higher taxes
Units of defence services

This would maximize the number of seats. Following Gillespie,[1] Diagram 1 attempts to illustrate the determination of the optimal level of defence unit provision. To go beyond the optimal quantity would lose more seats because of higher taxes than it would gain as a result of more defence; and conversely for a retreat from the optimal provision.

In reality, of course, there is a whole panoply of different taxes and expenditure programs, not to mention the more complex instrumentalities that can, at least in the case of regulation, be conceived of as implicit simultaneous taxes and expenditures. And there are any number of variants of each of the taxes and expenditure programs.

Few, if any, of the particular taxes or expenditures impact equally on all voters. All, however, can be expressed in terms of additional seats won or lost at various dollar levels of taxes and expenditures. Still following Gillespie, the optimization can be conceived of in terms of equalizing <u>total</u> marginal political costs and total marginal benefits where the horizontal <u>sum</u> of the downward sloping marginal benefit curves - the <u>total</u> marginal benefit curve - is equated with the horizontal sum of the upward sloping marginal cost curves - the total marginal cost curve.

The situation is illustrated in Diagram 2 where curves $C^0$, $C^1$ or $C^2$ represent the marginal political costs of three different tax structures. (Each tax structure is represented by a separate curve: different rates of tax imposed on a particular structure are represented by movements along the relevant curve.)

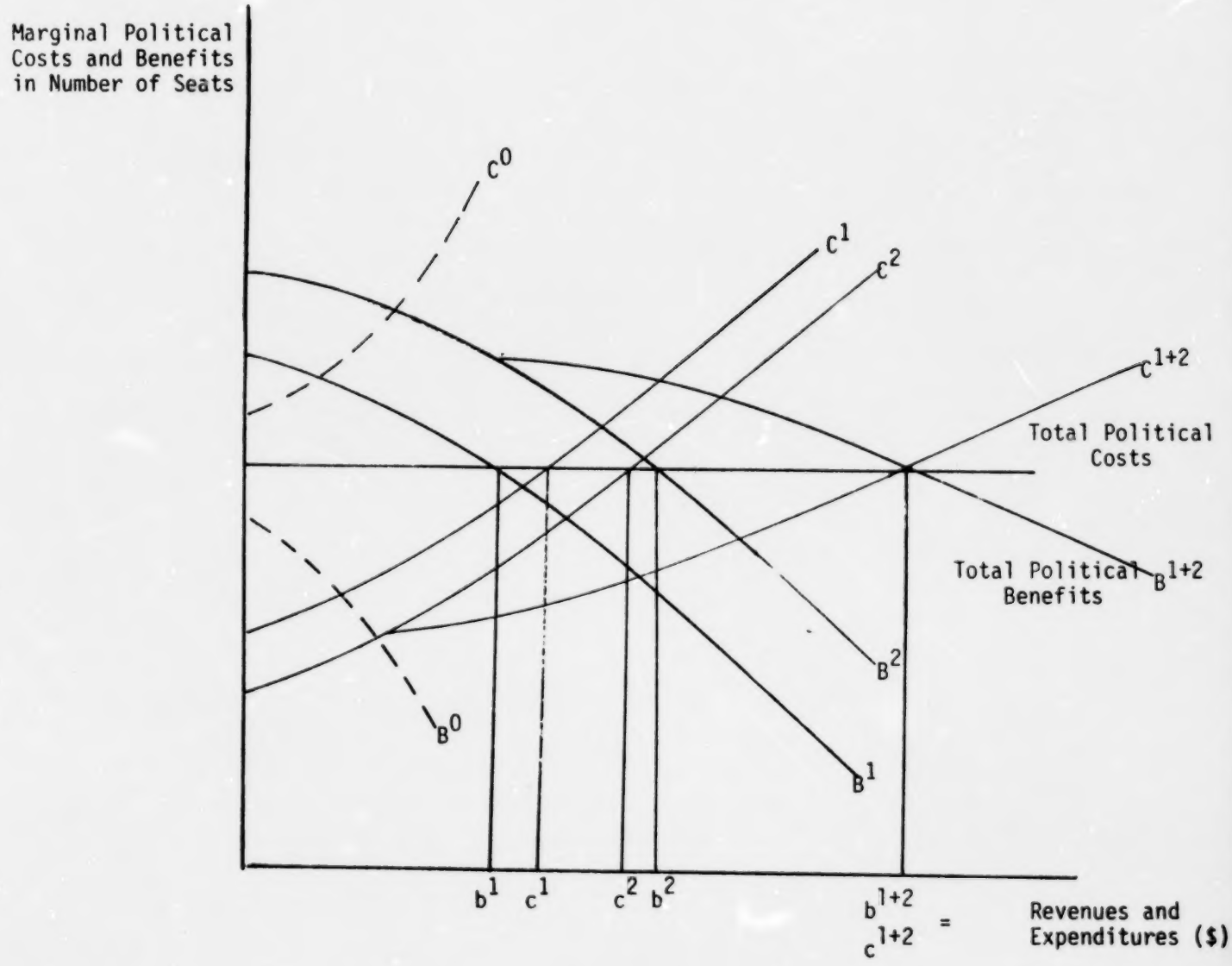
Similarly, curves $B^0$, $B^1$ and $B^2$ represent the marginal benefits of three different expenditure programs, where each expenditure program structure is represented by a separate curve. For each expenditure program, differences in the level of funding, given that structure, are depicted as movements along the curve. The horizontal sum of the marginal cost curves $C^1$ and $C^2$ results in Total Marginal Political Cost Curve $C^{1+2}$. In the same way, the Total Marginal Political Benefit Curve is shown as $B^{1+2}$. The optimal total level of revenues and expenditures, that is to say, the level where the number of parliamentary seats won is maximized, occurs where the Total Marginal Cost Curve intersects the Total Marginal Revenue Curve. Moreover, and importantly, it must be recognized that this involves funding program $B^1$ to the extent of $b^1$ and $B^2$ to the extent of $b^2$. Tax $C^1$ is used to raise revenues of $C^1$ and $C^2$ is used to generate revenues of $c^2$. That is to say, the <u>marginal political costs and the marginal political benefits are equal for each tax structure and each expenditure structure depicted.</u>

$C^0$ and $B^0$ can be looked upon as taxes and expenditures, respectively, that are not deployed because the minimum marginal cost of $C^0$ exceeds the optimal and the maximum marginal benefit, $B^0$, falls short of the optimal. All the tax and expenditure structure that are potentially feasible but are not in play can be presumed to be of this type. If this were not true, they would be adopted and deployed to some extent because at least their initial marginal benefits and marginal costs would be preferable to the equilibrating levels depicted in Diagram 2.

**Diagram 2:**

**Optimal Level and Mix of Taxes and Expenditures**

**In Terms of Parliamentary Seats**



## END NOTES

1. Gillespie (Summer, 1983) p. 189.

2. Ibid., p. 186.

## REFERENCES

Gillespie, Irwin, "The 1981 Federal Budget: Muddling Through a Purposeful Tax Reform", Canadian Tax Journal, (Nov.-Dec. 1983) Vol. 31, No. 6, pp. 989-1001.

Gillespie, Irwin, "Tax Reform: The Battlefield, the Strategies, The Spoils, Canadian Public Administration, 6 (Summer, 1983), Vol. 26, No. 2, pp. 182-202.

## 5. DETERMINANTS OF THE POLITICAL COSTS OF ALTERNATIVE TAX STRUCTURES

Leaving aside for the purposes of this paper the determinants of the political benefit (program expenditure) curves, tax reform becomes politically feasible when and only when alternative tax structures (including modifications in existing structures) can be devised that involve lower political costs than those currently being display or voter perceptions about the merits/demerits of alternative extant tax structure(s) change for some reason. Tax functions that have lower initial costs (lowest y intercepts) and the most gradual upward slopes to the right are politically preferable to those that have initially higher marginal political costs and/or rise sharply to the right as tax rates are raised. The determinants of tax reform can therefore be depicted as the determinants of the vertical intercept and slope of the marginal political cost functions, where every modification of an existing tax structure that alters its acceptability is conceptualized as a separate tax function - as are, of course, any tax structures not currently in effect.

Gillespie's formulation emphasizes organizational costs as a major determinant of the initial marginal political cost - the marginal political cost of introducing a tax even with a low effective tax rate. Consider the public choice line of argument advanced earlier with respect to the factors affecting the strength of lobby groups. Opposition groups will form and vociferously fight potential tax changes that would bear adversely upon them when taxes are imposed on a few "collection

points" which enjoy inexpensive communications with each other and the stakes (tax liabilities) are material relative to these low organization costs. By the same token, if the taxpayers are already organized, perhaps for some other purpose, the additional costs of mounting an attack or defence are extremely small relative to almost any stakes.

The converse holds for potential taxpayers who are numerous, and not in touch with one another. Organizational costs are high relative to the initial stakes where organizations have not been previously formed for some other purpose. In Gillespie's words:

> "The introduction of a new tax provides an announcement effect which rallys political opposition of all sorts: within the legislative, in the press, and among the citizens who are going to be taxed. The visibility of a proposed new revenue-raising activity can bring together opponents of disparate stripes for organizing opposition. There are large start-up costs of organizing these disparate political elements into an effective opposition to the government's proposed new tax ... The continued opposition to the tax depends on the effective tax rate ... Because of the large initial start-up costs of co-ordinating and organizing effective opposition, there exist economies of scale which can be explained as additional taxpayers become involved in the "politics" of opposing tax rate increases. Hence political opposition grows at an increasing rate as the effective tax rate rises.[1]

Closely related to organizational costs as a determinant of the position of the political cost curve associated with each tax base is the phenomenon of "vertical competition", in Gillespie's terminology. In a federal system at least three levels of government require revenues. They do not have, however, three distinct sets of constitutionally exclusive tax bases. In particular, the federal government has no constitutional limits on its taxing powers under the constitution while the provinces

are not empowered to levy indirect taxes (as defined by the courts).

The Constitution not withstanding, government that have "occupied" a tax base historically are not indifferent about the taxes imposed by another level of government on the same, or approximately the same, base. There are several interrelated reasons for the hostility to "interlopers". First, taxpayers may incorrectly assign the "blame" to the "wrong" government; second, taxpayer opposition probably mounts exponentially as effective rates rise on a given tax base. Thus the political costs of future revenue increases by the "prior" occupant are raised even further; thirdly, with higher tax rates evasion and avoidance becomes increasingly attractive and enforcement costs are raised.

The fact that both the federal and provincial governments (except Quebec) levy taxes on the same federal personal income tax base is a source of provincial government disquiet when the federal government makes changes to that base without prior consultation, much less consent. Revenue reducing changes allow the federal government to take the political credit but shift about half of the costs on to the provincial governments. The same is true of the corporate tax for those provinces that levy taxes on the federal corporate tax base. (All the provinces except Quebec, Ontario and Alberta.) Revenue raising federal income tax base changes can also pose special problems for provinces where the particular industries are concentrated and are therefore especially influential.

Because they are always organized and financed, the opposition of the provinces to federal tax changes is of crucial importance. They can retaliate by being intransigent in their negotiations with the federal government even on seemingly unrelated matters. They also can mount, or threaten to mount, effective publicity/propaganda campaigns, directly or indirectly, aimed at raising the opposition by federal voters.

Provincial governments are, in effect, the most powerful of all lobby groups.

"Vertical competition", by which Gillespie means the shifting of tax changes through changes in product prices to non-residents, can also affect the position of the political cost curves associated with particular tax bases. A Canadian monopolist selling output largely in foreign markets is not as likely strongly to oppose a tax increase that can be readily passed along and/or is not likely to be able to stir up opposition by groups which are politically salient domestically. Retaliation by other governments is not unheard of, however. They too, can be effective tax change opponents for the same reasons as provincial governments.

Although Gillespie does not deal with them, the tax shifting phenomenon poses many additional questions for the analysis of the determinants of the success of tax reform proposals. Let us suppose that in the long run all taxes or capital are ultimately shifted because investment declines following a tax increase until the capital stock has declined relative to the labour stock and the after tax reform to capital

restored. The owners of capital certainly suffer an immediate capital loss but the loss is less than the present value of the expected revenue stream. The present value of the stream of expected before tax labour income must also fall. This will not, however, be capitalized. That capital owners would oppose such a tax change is obvious - how effectively presumably would depend upon the form and quantity of the higher tax. Is it not possible, however, that labour would support such a capital tax in the mistaken view (given our assumptions) that those who pay the tax ultimately bear it?

Full long run shifting, a not implausible scenario, would be so gradual and the impact so indirect that one might question the feasibility of convincing the long run <u>indirect</u> losers of their potential future losses. Perhaps greater awareness by organized labour would not necessarily lead to higher political costs if, as seems plausible, the least skilled workers would be the most adversely affected. They are not organized, generally speaking.

Gillespie considers changes in voter/taxpayers preferences as a factor that can alter the political costs of particular tax basis. It might to reserve the term "preferences" as a synonym for individual tastes that, in conventional economics, are assumed to be constant. Choices change only in response to changes in income or changes in relative prices - including implicit (shadow) prices. Obviously, when perceptions about prices change, this has the same effects as a change in the underlying prices. Propaganda can therefore be conceptualized as

the manipulation of perceptions concerning relative prices - a subject already dealt with.

Higher compliance costs can be thought of as an increase in the tax burden. Higher collection costs reduce the net revenue and hence necessitate a higher effective tax rate - to realize the same after administrated cost revenue.

What Gillespie does not deal with is the relationship, if any, between the perceived degree of fairness of a tax structure and its political costs. This is not surprising, for a basic public choice notion is that self interest is the primary, and perhaps the sole, human motivation. Empathy is either ruled out or dealt with deficiently. Yet the whole notion of fairness seems to suggest that the satisfaction of individual A is affected by the satisfaction of individual B. While the principal political support for the progressive redistribution of income/wealth no doubt comes from low income groups, the actual or potential winners under such a policy, it is not unusual to find support for this concept of equity also coming from upper income individuals.

Three explanations perhaps will suffice. They essentially reject the sentiment of empathy except as a rhetorical flourish designed to lull the ill-informed. One view is that redistribution occurs (to the uncertain extent that it does) simply as a sop to low-income groups. It is, in this view, simply the price for political stability. In other words, the untrammelled market system would create such massive income/wealth disparities that the losers would revolt and

confiscate the private property of the wealthy - using violent means if necessary. Another possible rationale for upper income taxpayer/voter political acquiesance can be derived from a kind of Rawlisian notion that tax structures are like constitutions - the fundamental provisions are expected to persist over substantial time periods. As a consequence, taxpayers/voters considering potential changes not only have to take into account their current income/wealth situations but also the non-zero probability that their own circumstances will differ markedly, and for the worse, in the future.

Higher taxes now to finance a degree of redistribution now can be conceived of as a (compulsory) insurance premium on a policy that will partly compensate for future income/wealth losses. The bigger the likely perceived future losses and the greater the perceived probability of their occurrence the more acceptable - the less the opposition - to the extra tax burden resulting from current redistribution.

Still another possibility may be suggested. Although there is great uncertainty concerning the ultimate incidence of taxes, virtually all students of the matter would concede that the actual degree of progression is a great deal less than the nominal degree built in to progressive personal income tax rate structures by virtue of concessions, incentives and "loop-holes". Tax shifting reduces even further the real degree of redistribution. Furthermore, when one takes into account the ultimate redistribution effects of other policy instruments, including regulations, and standardizes for age/sex composition,

it seems plausible that the degree of real net redistribution is not large. Indeed, it might be regressive. Assuming this is a valid reading of the situation, is it not conceivable that informed losers under nominally progressive taxes acquiesce for the simply reason that they expect that compensating gains, or more than compensating gains, will be forthcoming elsewhere in the fiscal/regulatory system? By definition, informed voters think in real net terms: only uninformed voters think in nominal gross terms.

In this and the three preceding sections the reader has been provided with a sketch of the history of tax reform in Canada, an exposition of a public choice framework of analysis, and a brief discussion of the determinants of the political costs of alternative tax structures. From these combined perspectives six particular tax structure reform proposals, that might be viewed as case studies, are now presented: their origins, the principal protagonists in the ensuing struggles and their fates to date are briefly set forth. The objective here is not to analyze their merits in terms of the usual criteria of neo-classical economics but rather to describe what actually happened. These descriptive case studies are based solely on published material. What happened behind closed doors, so to speak, is often of equal or greater importance in understanding what occurred but must necessarily be more speculative in nature. These speculations are reserved for a final section, as is the more explicit delineation of the cases from a public choice point of view.

## END NOTES

1. Gillespie, p. 186.

## REFERENCES

Gillespie, Irwin, "Tax Reform: The Battlefield, Strategies, the Spoils, Canadian Public Administration, (Summer 1983), Vol. 26, No. 2, pp. 182-202.

# 6. THE ABOLITION OF FEDERAL ESTATE TAXES AND THE INTRODUCTION OF THE TAX ON CAPITAL GAINS

## Death Taxes

Because inheritance is a significant method of concentrating wealth, the general objective of governments in taxing estates of deceased residents is to diffuse pools of capital in order to achieve a more equal distribution of wealth. In Canada, as a source of revenue death taxes were not important, making up only "1.5 per cent of the total tax."[1] Instead, they have been considered more "a matter of social philosophy"[2] and used as a policy instrument.

Various objectives and types of taxes may be distinguished.

1. Society may wish to limit a person's right to dispose of his or her property at death. Society says to individuals that they may use their property during their lifetime, but that their title ceases or is curtailed at death. In this case, an estate tax of the federal type is the appropriate approach. If society feels that small estates may be left but not large, progressive rates are in order. If society wishes to allow free bequests up to a certain amount, an exemption is in order. If it wishes to confiscate estates in excess of a certain limit, a 100 per cent rate above that limit would apply.

2. Society may wish to limit a person's right to acquire wealth by way of bequests, i.e., without his or her "own effort." This objective is served by an inheritance tax, imposed on the heir. Again, society may wish to differentiate between small and large acquisitions, thus calling for progressive rates. Given this objective, it would in fact be more sensible to combine such accessions from all sources, i.e., to relate progression to total accessions from bequests over lifetime, rather than to each specific inheritance. This is referred to as an "accessions tax."

3. Society may have the more general objective of achieving a more equal distribution of wealth. Since the institution of inheritance is one of the major factors making for concentration of wealth, an inheritance tax or,

better, an accessions duty is one of the more effective approaches to this problem. The logic of this approach, however, would call for rate progression relating to the heir's total net worth (including the bequest and his or her prebequest wealth) rather than on the size of the bequest only. Moreover, a supplementary measure might be a concentration-of-wealth tax, applicable to the combination of wealth through marriage.

4. Finally, the objective may not be one of imposing a separate tax on transfers at death, but simply to correct the income tax and fully implement the accretion view of income of including the receipt of bequests as part of the taxpayer's income under the income tax. This objective was previously noted as a possible rationale for a wealth tax. If implemented as a death duty instead, it would call for imposition of the tax on the heir, but the rate in this case would depend on the heir's other income. This approach would call for liberal averaging allowances so as to avoid the penalty of bunching under progressive income tax rates.

There is no reason, of course, why these four objectives should be mutually exclusive. Society may wish to integrate bequests into the income tax as suggested under 4, while at the same time pursuing both objectives 1 and 2. Thus, it may wish to impose both an estate tax, thereby limiting the testator's right to dispose, and an inheritance tax designed to limit the heir's right to receive and/or to compensate for noninclusion of bequests into taxable income. Choice among these objectives and selection of the appropriate tax device, it should be noted, is an issue which should be distinguished from the further question of how high rates should be and how far equalization should be pushed.

Moreover, the design of death duties must again address itself to the proper definition of the taxpaying unit, involving society's view of the family. While people may agree that there should be some limit to the leaving or receiving of bequests,

most people feel that this limitation should be less strict if the recipient is in a close family relationship to be deceased."[3]

The Ontario Committee on Taxation stated in their Report of 1967:

> "Death taxes, if adequately protected by gift taxes, are admirably suited to control the growth in this country of an economically powerful minority whose influence is based upon inherited wealth. By this device, the amount of capital that passes from one generation to another can be controlled, an essential safeguard for the basic fabric of a democratic society. Moreover, because the tax is not payable until death, this end is achieved with a minimum deterrent to working and saving during a man's earning and creative life."[4]

The first federal death tax in Canada was introduced in 1941. The Minister of Finance announced in his budget speech that: "The compelling need for revenue which induces us to enter the new field arises from the war, but I would not suggest that this new Dominion tax is a temporary wartime measure only."[5] But the last federal Estate Tax Act [6] was introduced in 1958 and its inadequacies became apparent in the next ten years. In October 1968, the government took its first step in the plan to reform the system of taxation in Canada. Writers at the Financial Post described the reforms as increasing "the probability of new complications in the already wildly complex and uncertain field of death taxes."[7] The new Estate Tax Act would impose a tax at progressive rates on estates of persons who died domiciled in Canada. The tax was "calculated by reference to the aggregate taxable value of the estate after permitted deductions and exemptions."[8] The legislation would allow an exemption for estates valued at less than $50,000 and there would

be no tax on interspousal transfers of estates. However, the rates would be dramatically raised, reaching a maximum of 50% at an estate value of $300,000.

The federal estate tax was deemed to be a debt "incurred by the deceased immediately prior to his death."[9] Thus, it was distinguished from provincial succession duties that were levied on beneficiaries of the deceased in Ontario, Quebec and British Columbia. Section 91(3) of the Constitution Act, 1867 gave the federal government the right to impose any taxation for Dominion purposes. Under Section 92(2), the provinces only have the right to levy direct taxes within the province. "A direct tax is one which is demanded from the very person who it is intended should pay it."[10] Thus, they must find something within the borders of the province to tax. These provinces then, taxed the receivers of the wealth. To avoid double taxation the federal government allowed a reduction on estate tax in the three succession-duty provinces. In addition, Alberta had begun to rebate its receipts from the federal estate tax to Albertans in 1967. The Alberta government sought to stop the outflow of investment capital by this move. The result was indeed a "tax jungle."[11]

## The Nature of the Problem

There were many opponents of the death tax. Some had made themselves known at the Public Hearings of the Royal Commission on Taxation (the Carter Commission) in 1963-1964. The Commission's terms of reference were to discover whether the basic purposes of the death tax were consistent with the objectives of a sound tax policy in Canada; to search out anomalies and inequities in the system; and to investigate the extent to which measures encouraged tax avoidance, discouraged initiative and increased foreign ownership.

The submissions to the Commission led the Financial Post to report: "For governments in Canada, death taxes are not an important source of revenue...But the economic damage they can do is staggering."[12] The Commission Report recommended the abolition of estate taxes along with the establishment of a comprehensive income tax base that would include the gains accrued to capital at the time of death and the inclusion of bequests in the tax base of the recipient.

Submissions to the Carter Commission argued that those most hurt by estate taxes were small family-owned businesses and farms. If this was true, the general objectives of the legislation had failed completely. In its brief to the Commission, the Shoe Manufacturers' Association of Canada stated that: "The unreasonably high level of succession duties has been the largest single factor both in encouraging the sellout of Canadian enterprises to foreign interests and in eliminating from

the economic scene continuing independent family businesses."[13] The key problem for such businesses was the highly illiquid nature of their assets. To discharge tax liabilities incurred at the death of the sole proprietor, the estate might be forced to dispose of assets that made the business viable or to dispose of the business altogether. The arbitrariness of the timing of this tax also contributed to its burden. The estate might be forced into a very unfavorable market.

Yet a special study prepared for the Carter Commission concluded that there was "no empirical evidence that estate tax is a major factor in the sale of small businesses."[14] The authors had asked for factual evidence of cases where estate tax was the dominant factor in the sale of small business. They found though, that the fundamental reason for a sale usually lay elsewhere. This was the same conclusion that had been reached by the Colwyn Committee in the United Kingdom in 1927 and by the United States Treasury Department.

Another criticism of the estate tax was that it conflicted with provincial succession duties. The two systems of taxation made estate planning excessively complex. The Association of Canadian Distillers argued that the federal government should abandon the field of death taxes to the provinces. The loss in revenue would be insignificant; the move would cement governmental relations and it would lessen the complications for estates dealing with both types of taxes. The fact was that the provinces already received 75% of this revenue "through abatement of the estate tax or in the form of grants from the federal government."15

Other submissions argued that the provinces that collected their own death duties should vacate the tax field in order to promote "greater legislative uniformity."[16] These groups felt that estate planning had become overly complex because of the varying rules that applied between provinces in regard to the calculation of death duties. For instance, British Columbia used an "accessions" basis for death duties. This meant that a beneficiary living in the province would be taxed on the property he received, no matter where the property or where the deceased had lived. Ontario, on the other hand, taxed on a "transmissions" basis. With this system, the province only taxed a beneficiary in Ontario if the deceased person was domiciled in the province, but taxed property in the province wherever the beneficiary resided. From this it can be seen that one nationally administered system would greatly ease the problems in the administration of large estates.

Finally, the Canadian Bar Association submitted that an "excessive amount of property" was tied up for long periods of time in trusts to avoid death taxes. This submission pointed to the variety of tax planning stratagems devised to avoid death taxes. "These plans in themselves frequently restrict(ed) the company's proper development and expansion, and may (have) add(ed) to production costs."[17] For instance, the use of inter vivos trusts reduced the yield to the government and also reduced the amount of capital available for investment in the economy.

It seemed then, that in the opinion of the majority of those expressing their views to the Carter Commission, the general purpose of redistributing wealth by controlling the growth of an economically powerful minority was not being met by the estate tax. Instead, 'the man in the middle', without sufficient resources and/or foresight to avoid the tax, was being hurt the most.

## Reactions to the Carter Report

The most striking recommendation in the Carter Report was the inclusion of capital gains in the tax base. This meant that at different stages in the life of an asset it would be valuated and the increment over the original cost would be taxed. Since capital gains would be allowed to accrue without taxation until an event that would trigger a realization of these gains occurred, the death of a taxpayer holding assets would mean that the gains that had accrued on this property would escape taxation. No event would have occurred to trigger recognition of these gains. Therefore, it was proposed that there be a 'deemed disposition' of property on the death of an owner. When the property was transferred by way of bequest, it would be deemed, by virtue of the Income Tax Act, to have been disposed of at fair market value. At the same time, the beneficiary (one that was outside the family unit) would have to include the fair market value of the bequest in his income and be taxed thereon.

The Commission also emphasized that taxes should be allocated among tax units in proportion to their ability to pay. The Report stated that "taxes payable by units with the same (tax) bases but different family responsibilities should reflect these relative differences."[18] Therefore, it was argued that the unit of taxation should be the family unit; it was "the basic economic unit in society"[19] and that fact should be reflected in the tax system. A family unit was defined to include a husband and wife and any dependent children under the age of majority. Any transactions between family members would be ignored for tax purposes under this system.

With the family as the unit of taxation, bequests to widows or dependent children would escape the capital gains tax. The tax would be deferred until the property was withdrawn from the family unit. If there was a disposition of the property by sale to another unit of taxation, the capital gains would be taxed. Similarly, "unrealized gains on property withdrawn by children should be taxed as income to the original family unit in the year in which the children withdraw."[20] Children were to be deemed to withdraw and form a separate taxation unit on reaching the age of twenty-one.

If a father died, leaving an estate to a child over the age of twenty-one, "the single event of the father's death (would give) rise to two concurrent taxes on the same property, both at individual progressive rates."[21] The imposition of a tax on gains in the value of the deceased's capital property that were deemed to be realized in conjunction with a tax on the value of the

bequest that had to be included in his income was a heavy burden to bear. It was argued that this would result in a fairer system of taxation. These two concurrent taxes were a mechanism for redistributing wealth in Canada. Yet critics argued that the 'average Canadian' would be hurt the most by these reforms. They felt that such a system would discourage economic growth by dissipating investment capital and discouraging saving. Also, taxing a bequest in the hands of a donor as well as a donee seemed like double taxation.

First, it was argued that the proposed system increased the necessity of estate planning for the average Canadian. The Estate Tax Act allowed an exemption for estates valued at less than $50,000. Many Canadians could thus avoid the tax entirely. However, under the system of taxing capital gains at the time of death "a man could be made relatively worse off than his peers, merely because he had not the knowledge, or could not afford the advice to deal with the more complex system."[22] Those with estates worth less than $50,000 would lose under this system.

Second, in a paper delivered to the Annual Conference of the Canadian Tax Foundation in 1967, W.M. Carlyle argued that the proposals were "too severe a restriction on the formation of private capital."[23] Carlyle saw this "continuing denial of any right to save and to pass it on to the next generation"[24] as an impediment to economic growth. There would be a yearly diversion of capital from productive investment to current expenditure as a result. He believed that the "empire building" incentive was needed to stimulate people towards more dynamic investments. S.

Legge also argued against the dissipation of capital that would occur if the tax on accrued gains of the estate impacted simultaneously with the tax on the recipient's income from the bequest. He felt that the "disinvestment effect"[25] of such taxes would be multiplied by inflation and economic growth.

Thus, the Carter proposals would not provide relief for those seen as suffering under the Estate Tax Act. The "buck is a buck" programme seemed to further penalize small estates and their beneficiaries. It could harm those less sophisticated in estate planning. The severeness of the measures could be a detriment to economic growth.

## The White Paper on Tax Reform

The next step after the Carter Commission Report in the government's programme to reform the system of taxation was the tabling of the White Paper on Tax Reform on November 7, 1969 in the House of Commons. I.H. Asper referred to this document as the "Benson Iceberg"[26] because it concealed most of its body beneath the surface. The White Paper proposals included the taxation of most capital gains at full progressive rates. The government had not accepted the Carter proposal of taxing all members of a family as one taxpaying unit. It was allowed that transfers of property between spouses would be tax-free. A wife would be deemed to have acquired the property at its cost to the deceased (which would be deemed to be the value on valuation day) and no estate tax would be levied. But a beneficiary son or

daughter could not avoid the estate tax. To ease the tax burden though, these beneficiaries would be able to defer the capital gains tax until gains were actually realized; for instance, on a disposition of the property through sale (s.3.42 of the White Paper). Clearly, this would encourage taxpayers to 'lock-in' the assets they acquired because any change in their holdings would trigger a tax on values that may have been growing for long periods of time.

The public hearings on the White Paper proposals were heard by the Standing Committee on Finance, Trade and Economic Affairs of the House of Commons in 1970. They showed that there was extensive dissatisfaction with the combination of the estate tax and the capital gains tax. Groups representing farmers and closely held businesses complained loudly of the double burden. The Vanier Institute of the Family was concerned with the sociological impact on the family where taxes might prohibit intergenerational transfers of property. Groups forwarding the interests of the provinces opposed the federal estate tax. Insurance industry groups favored the estate tax over the capital gains tax.

The Canadian Federation of Agriculture submitted that the estate tax was already excessive and a major obstacle to the maintenance of the family enterprise system of farming. The fact that the provinces with many farmers, Alberta and Saskatchewan, had begun to rebate the provincial share of the tax to their residents was evidence to support this view. The B.C. Sugar Refining Company brief stated that the proposed combination of

taxes would mean the eventual disappearance of the individual farmer. It could be argued though, that changes in the structure of the farming sector would improve efficiency and thus, encourage economic growth. It may be "just what the ... country needs."[27]

Yet the farmers were a powerful group and the unique features of the existing farming business made it particularly vulnerable to these proposals. Farms have "disproportionately large capital holdings relative to income earned."[28] The value of the land, buildings and equipment would mean a high rate of estate tax. Thus, the farm estate would have a heavy tax liability at the date of the death of the sole proprietor. Farm estates are usually cash-poor and assets would have to be sold to pay the tax. The selling of assets would trigger the capital gains tax and also shrink the farm holdings, jeopardizing "its efficiency and viability."[29]

The Canadian Construction Association and the Canadian Trucking Association represented industries characterized by closely held family corporations. They both argued that the proposed taxation system would result in the inevitable change of control in small companies upon the death of the principal owner. Again, whether this change might ultimately be better for the economy was not in issue; these groups were fighting to hold on to what they had. The C.T.A. said it was "legalized hijacking" and would be "significantly more onerous than the equivalent U.S. provisions."[30] Still, the Carter Commission study had found that: "an offering price too attractive to resist, a lack of

management capacity in the remaining family, such as a spendthrift son or a disinterest in the business ... were among the most prevalent"[31] reasons for sale.

The Vanier Institute of the Family submitted that the estate tax reinforced the 'generation gap'. It was argued that it was important to allow generations to pass on property within the family. Eliminating death taxes "would preclude the state from any longer interjecting its value judgments"[32] into family property decisions. Support for this view could be found in any group with extensive property holdings concerned with the capacity of related people to retain wealth. The harsh consequences resulting from a tax on capital gains and death taxes falling at about the same time could prohibit parents from leaving property to their children. It was said that such provisions conflicted with "one of the most powerful of human motives, love of parents for offspring".[33]

The provincial submissions, such as those from the Government of Ontario and the Quebec Chamber of Commerce, had a constitutional motivation. They felt that estate taxes should be "exclusively reserved to the provinces."[34] In both Quebec and Ontario, the provincial governments levied their own death duties. Thus, these proposals would cut into the revenue received by these provinces. By taxing the gains that had accrued to the estate first, the value of the bequest of the donee on which the provincial duty would be calculated would be less. By taxing the bequest as income of the donee, the federal government would be making the provincial duties seem redundant.

Although the provinces would be getting their share of the yield from this federal tax, they argued that by administering death duties themselves they were better able to "keep track of the disposition of property within their boundaries."[35]

The Investment Dealers Association expressed concern for the depletion of investment capital that would result from the generational dissipation of estates. It was felt that the proposals would "reduce the incentive to save."[36] This group recognized that a tax on capital gains was inevitable and so argued for the repeal of the Estate Tax Act. On the other hand, the Canadian Life Insurance Association and other groups associated with the insurance industry supported the continuation of estate taxes with softer capital gains tax measures. Estate taxes made permanent life insurance plans (with premiums paid by the beneficiary only) more attractive. Such policies could be used to decrease the value of the estate on which the tax would be calculated. A comprehensive capital gains tax would catch the gains on term plans and variable annuity plans, making them less attractive investments. Therefore, the insurance industry could only lose by the replacement of the estate tax with a capital gains tax.

Generally, the groups making submissions on the White Paper to the House of Commons Committee emphasized the need to integrate the various death duties and the capital gains tax. Many alternative proposals were received. Eventually eliminating the estate tax was suggested by a variety of sources ranging from the Canadian Bankers Association to the Canadian Construction

Association. The Canadian Institute of Chartered Accountants proposed increasing the exemption from the estate tax to the level of estates valued at $200,000 and reducing the rate. The Board of Trade of Metropolitan Toronto submitted that the capital gains tax should be deducted from the value of the decedent's estate.

All of the groups felt that the White Paper proposals were too harsh. The deferral of tax on unrealized capital gains at the time of death was felt by many to be a meaningless concession because of the need to liquidate assets in order to pay estate taxes. Despite the fact that a capital gains tax, a levy on capital increases, "is a different sort of animal from a tax on estates - which is a levy on the transmission of capital,"[37] the two systems impacted too harshly to be able to intermesh without one or the other system giving way.

Although some economists argued that small businesses were no longer "a force for progress and productivity",[38] and forcing sales would encourage change, existing small businesses could not accept this. Richard Bird felt that equity and social justice demanded this type of wealth tax and the real answer to the problem was to revise death taxes "to concentrate them more sharply on great concentrations of wealth and perhaps supplement them by low-rate annual net wealth tax".[39] But certain industry groups needed large amounts of capital and they were very vocal. Bird felt that the degree of general public apathy on this question was surprising, while the "... select sector of public opinion which is normally most heard on tax matters appears to

consider the taxing of wealth to be close to the ultimate sin - robbing the deserving rich, taking away the rewards needed to spur entrepreneurship and the capital needed to foster it, destroying family businesses, fostering the sell-out of Canada to the foreigner and in general being both inequitable and economically disastrous."[40]

Final Outcome: 1971

> "There is consistency for you! In 1969 before the introduction of the White Paper...the Minister put the country through a lot of turmoil and trouble by an increase in estate taxes in an attempt to reduce the tax on very small estates. Now, with great fanfare the Minister announces its abolition, also for the very best of reasons."[41]

The opposition in the House of Commons was derisive of the process of reforms but not of the end-result. To lessen the impact of the new capital gains tax at the time of death, the Estate Tax Act was made inapplicable to deaths occurring after December 31, 1971. The Minister of Finance announced the decision to abolish the estate tax in the Budget speech in June, 1971. He defended it as "a reform founded on an unprecedented process of public participation during the White Paper debate - a process of good democracy, good politics and good government."[42] It was estimated that federal and provincial revenues would decrease by $65 million in 1972 without the estate tax. However, this loss of revenue would be counteracted by the "$80 million revenue"[43] estimated to result from the capital gains tax.

J. Deutsch, a former Economic Council of Canada Chairman, noted that the change clearly demonstrated "the primacy of politics over economics in the making of public policy ... Governments are more likely to hear the voices of public opinion than the preachings of economists."[44] Richard Bird argued that on moral, social and economic grounds the estate tax should be raised. It was a close approximation to a wealth tax; therefore, it had a redistributive effect on the wealth of society. Also, efficiency and economic growth would be encouraged in a system that forced the sales of marginal small businesses. He felt that the real problem was that there was "no obvious politically significant vested interest to support it."[45]

The leaders of the three opposition parties were reported as being critical of the budget "but not harshly so."[46] This is indicative of the kinds of concessions that had been made. The Globe and Mail editor wrote: "we probably haven't had as many somethings for as many everybodys in our history."[47] The headline read: "Pragmatic bill capitulates on major tax reform proposals."[48] The New Democratic Party Leader, David Lewis, called the reform "major tinkering."[49] The general view seemed to be that the changes that were finally announced in the June 1971 Budget could have been made without the years of investigation of the system that had preceded them.

The industry groups reacted favorably to the changes that had been made since the White Paper proposals. I.H. Asper called the Budget "a far superior tax plan" to the White Paper "if only because most people .. will accept it."[50] A member of the

investment community praised the "expansionary thrust"[51] of the Budget. Eliminating the estate tax would hopefully encourage more investment by releasing a burden on accumulated capital. "It takes more than one generation to build up a business ... If we want to see important Canadian businesses built, they will have to be allowed a run at it as American companies were in the days when that economy was at the state of development we are at now. The measure is proposed in that spirit."[52]

The construction industry and the Canadian Real Estate Association welcomed the abolition of estate taxes because "the small builder is still the backbone of the residential construction industry."[53] Of course, since the capital gains on Principal Residences were not to be taxed, expensive houses became particularly attractive investments. Formerly, a decedent's house would have been valued and included in the estate for the purposes of the death tax. Under the new reform, these houses escaped the tax net entirely.

The insurance industry also seemed to have made a comeback from the drastic blows threatened by the Carter Commission and the White Paper. Life insurance was to be "ignored for capital gains purposes."[54] Under the Estate Tax Act, if the premium had been paid by the deceased, the proceeds would have been included in the value of the estate on which the estate tax would have been calculated. Under the Carter proposals, the benefits from a life insurance policy would have been taxed in the hands of the recipient. It is indicative of the power of the insurance industry's lobby groups that even in 1977, when the government

again tried to impose a tax on life insurance policies, the proposals did not go through. The "government bowed to insurance industry pressure and abandoned its plans - pending further study - for the so-called death tax on the investment element of life insurance policies."[55]

The abolition of the federal estate tax did not necessarily solve the problem of the crippling effect of the capital gains tax levied in conjunction with a death tax. This area of taxation was simply left for the provinces to resolve. As a result, nine of the provinces scrambled for the revenue immediately. The provinces moved in with "different regulations, rates and philosophies",[56] and left residents in a state of 'estate planning chaos'. Ontario, Quebec and British Columbia already had succession duty legislation in place but made many changes. For instance, "Ontario doubled its rates, then doubled its previously doubled spousal exemption, then found that its notch provision had the unintended effect of negating the doubled rates in certain situations and finally appointed a commission to review whether the retention of succession duties in Ontario was warranted."[57] Six other provinces hurriedly drafted legislation to fill the gap left by the federal government. Alberta had formerly rebated its portion of the federal death tax to its residents and did not plan to begin to administer one. (Alberta had a high proportion of farmers as residents and wanted to attract investment capital to develop its natural resources and industries.) Therefore, Alberta became a 'death tax haven' and other provincial governments watched anxiously to see whether

there would be a migration of their wealthy residents to Alberta. One year after the announcement of the abolition of the federal estate tax, B. Riddell of the Financial Post noted: "provincial balkanization has moved in earnest into the wealth-tax field."[58]

After the initial panic to enact death tax legislation, the provinces began to leave the field of death taxes one by one, partly because of competition among them for wealthy residents and partly because the yield was small. "Even doubling revenue would not render the (death) tax a major revenue producer relative to other sources. The trouble is that death is too infrequent an event."[59] P.E.I. was the first to follow Alberta as a 'death tax haven', indicating that the "potential revenue from this source (was) not great and (was) out of proportion to the cost of collection."[60] But the Ontario government that received $100 million in yearly revenue, could not abandon death taxes as easily. In 1977, only Manitoba, Ontario and Quebec retained Succession Duty Acts. The Manitoba N.D.P. government's Finance Minister S. Miller criticized Ottawa at that time, for leaving the death duty field in 1971. He felt that a uniform national estate tax would have been more appropriate. Thus, it seems that the provinces did not have the capacity to deal with the power that the federal government had left them. The administrative costs and confusions could not be dealt with at the provincial level. Today, only Quebec administers succession duties.

In the end then, the provinces were not able to fill the void that the abolition of the federal estate tax had left. It seems that with death taxes the government was forced to

disregard ideals of social justice in favour of a realistic response to the reactions of the most powerful groups affected by the reform proposals. Businesses involving large amounts of capital were clamouring against the taxation of capital gains. These businesses, both big and small, could not accept reforms in the taxation system which would so dramatically affect their fiscal positions.

The burden of both a capital gains tax and an estate tax was potentially overwhelming for businesses with a liquidity problem. Because the estate tax burden could fall at arbitrary and inconvenient times, it was a nuisance that made the searching out of loopholes a worthwhile endeavour for many entities. On the other side, the federal government was not keeping very much of the revenue that was collected anyway. This made it a relatively easy concession to make on fiscal grounds.

Still, it might be argued that a moral battle was lost with this concession. A "decision of death taxes inevitably reflects (a) decision on basic questions of social policy."[61] The government was forced to give up what could be considered a symbolic gesture towards a more equal distribution of wealth in society. The Carter Commission said that a tax with a more comprehensive base that included capital gains would have a 'fairer' impact on taxpayers. Its comprehensiveness was to have closed loopholes used to escape estate taxes. But the government only implemented a tax on half the capital gains. Besides, it must be remembered that the estate tax was a tax on <u>wealth</u>. A tax on wealth itself is clearly distinguishable from a tax on

earnings from wealth. By conceding the tax on wealth, the government allowed those who were already asset-rich to retain their position. By implementing the tax on earnings from wealth, the government sacrificed those striving to be asset-rich.

The indications from the process leading up to the abolition of the estate tax are clear. In order to change the weight of tax imposed on capital income, serious consideration would have to be given to those groups holding capital assets. Farmers, small businesses and the insurance industry stand out as major factors in any reforms in the taxation of capital-source income. These groups are very conscious of changes in the taxation system that would affect the private use of capital. They would also have the organizations to influence the outcome of reform processes.

Perhaps it is true that the 'have-nots' lost out with the abolition of the estate tax that was necessary in order to implement a capital gains tax. But firstly, their voice was not heard during the reform process and secondly, they might not have felt the results until much later when most of the provinces stopped administering death duties. Although one might have been able to foresee the result of having the provinces deal with death duties on their own, the battle on the issue of death taxes was already lost when the federal government made the concession. The issue of death taxes was not one of revenue it was one of fundamental social policy.

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# 7. REFORM OF THE TAXATION OF REAL PROPERTY IN ONTARIO

## Historical Overview

Canada's first property tax was introduced in 1793. It was a simple tax on selected forms of property. Changes were continually made in the legislation but by 1867, the Assessment Act was fully developed and contained most of the concepts and much of the wording expressed in the present-day Act. The Smith Committee on Taxation considered the Assessment Act after the changes made to it in 1904 to be the "legislative base for property assessment in Ontario."[1] It had undergone few fundamental changes since then.

Obviously, in 1967 when the Smith Committee made its report, this legislation was terribly outmoded. The Committee condemned the property tax as "both inherently regressive and inequitably administered."[2] As a result of the Smith Committee recommendations, the Government of Ontario took over the function of assessing real property from the municipalities in 1970. It announced its commitment to adopt full market-value assessment as the base for property taxes throughout the province "within five years."[3] At that time, the township of Mississauga actually did implement market value assessment of property within its boundaries.

Still, the province postponed the introduction of market value assessment until 1976, when the Treasurer Darcy McKeough announced a set of reform proposals during the Budget

speech. The proposed system would somewhat lessen the impact of the implementation of market-value assessment. The Blair Commission was appointed to study the McKeough proposals and on receiving the Blair report in 1977, the Government responded with yet another set of proposals. In January 1978, a revised White Paper on Tax Reform introduced the "Alternative System." The Alternative System modified the 1976 Budget reform proposals even further, by permitting most existing exemptions from property tax to continue and allowing different fractions of assessment to be subject to tax depending on the classification of the property type. The "Provincial-Local Government Committee" was then set up to consider the Alternative System proposals. In April 1978, this Committee submitted its report to the Government and in June 1978, the province shelved the reform plans entirely.

Clearly, from the amount of study that has been given to the area of property tax reform, there must be serious problems with the existing legislation. An official of the Revenue Ministry estimated that the nine years of study had probably cost the Government "millions of dollars."[4] But certain forces have been too strong to allow a new system to replace the "antiquated, ramshackle, unfair and confusing system which collects this province's largest single tax."[5] It has been politically impossible.

The Property Tax

The property tax has been called "a bulwark of local autonomy."[6] Municipal governments raise approximately "75 percent"[7] of their total revenue from local sources from this tax. Although it is an extremely unpopular tax, as "the most important single source of local revenue under local control"[8] it is a significant element in the Canadian tax system. The property tax could never be eliminated because of its impact on the governmental structure of the country. It is necessary for local governments to maintain appropriate powers of taxation; they are a "means of achieving an efficient allocation of resources between public and private uses and among public uses."[9] It is felt that efficiency in resource use and the welfare of society would be decreased if local governments were not given an independent source of revenue to finance their own expenditures.

In Canada, there are over "4,700 municipal bodies"[10] providing such services to the community as: water systems, education and health care. The costs of these functions are covered by grants from the provincial government and from revenue from local taxation. "Varying local tastes or preferences for public goods are better met if residents of each area are given the power to determine the collective goods to be provided in that area than if the provincial government were to provide a uniform level of services across the province."[11]

The Canadian system generally taxes the capital value of property. The capital value, as opposed to the rental value, is considered a better measure of property for assessment purposes. An assessment of the capital value of property tends to "take account of prospective alternative uses and to encourage recognition of the highest and best use to which the property might readily be put."[12] Land and improvements are usually included in the tax base. The Assessment Act defines the 'real property' subject to municipal tax in Ontario as including all machines and fixtures other than machines and equipment used for manufacturing and farming purposes. The annual levy on the owner, expressed in terms of 'mills', is based on the value of the real property that is contained within the boundaries of a municipality.

Valuation then, is essential to the property tax system. It provides "basic indicia of municipal taxable capacity and [at the same time] many province-wide grant and other programs of assistance employ this data in measuring the amount of the payment."[13] In principle, the value of property would be the current market value of all real property in the taxing jurisdiction but since only a small percentage is sold in a year, there is little market information by which to determine the local tax base. Thus, a variety of techniques must be used to assess properties and give them an artificial value on which taxes can be based.

Theoretically, valuation is based on the "willing-buyer, willing-seller" formula; that is, the price is established by the free play of bargaining between a seller and buyer, neither of

whom are under compulsion from particular circumstances to act. The Commission on the Reform of Property Taxes in Ontario (the Blair Commission) identified five alternative approaches to determining market value of real property:

> "1) A recent free sale of the property itself where neither the conditions of the property nor the market have since changed;
>
> 2) Recent free sales of identical properties in the same neighbourhood and market;
>
> 3) Recent free sales of comparable properties;
>
> 4) The price which the revenue producing possibilities of the property will command;
>
> 5) The depreciated replacement cost of the property itself."[14]

However, existing assessment methods purposefully discriminated against certain property types by over- or under-assessing the value. Annual assessments either confirmed earlier valuations or adjusted them on a formula basis and the practical effect "is that seldom does the annual assessment even approach the true market value."[15]

In 1977, the Blair Commission stated that "the property tax is a levy on wealth in the form of real property. As such, that wealth represents a stake in the community and it is fair to ask a person to pay towards local costs in the direct relationship to what he has at stake."[16] If indeed, the property tax was a price paid for consumption of municipal services, it would be neutral and non-distorting. The earlier Ontario Committee on Taxation (the Smith Committee) had agreed with the findings of U.S. studies that since property taxes were such a small portion of

the total costs of individuals and businesses, they had virtually no effect on the location and accommodations chosen by taxpayers, except within fairly narrowly defined areas. However insignificant the levy may be as a force on the taxpayers' behaviour though, the fact remains that it may be an unjust levy.

The property tax "has been labelled 'unfair' because unrelated to ability to pay, 'unrealistic' because unrelated to benefits and 'unsuitable' because it supports services unrelated to property."[17] "The tax is charged with being regressive, of being unfairly administered, of discriminating against property-intensive industries, of distorting the location of economic activity, of contributing to the development of urban slums, and so forth."[18] Although the property tax has not been seen to influence the chosen location of taxpayers, it is clearly very unpopular. Objectively, the burden of the real property tax does not result in a significant reduction in taxpayers' income, but their subjective evaluation of this burden determines public resistance to this tax. The property tax is highly visible because it is paid in a lump sum and this helps to make the issues involved in property tax reform even more political.

## The Problem

Interest in reform of the property tax legislation grew when the property tax revenues did not keep up with the costs they were intended to meet. F. Finnis points out that the property tax was originally intended just to provide services to

land, for instance, public works and planning. Rapid urbanization in recent times though, has increased the pressure on municipal budgets. Thus, the revenues from property taxes have been forced to provide for social programs and education in the community on top of their original role. "The most important problem is that property taxes are doing too big a job."[19]

The first thorough study of the assessment system in Ontario was undertaken by the Smith Committee. The assessed values of properties were examined relative to their market values (the assessment-sales ratio). It is understood that a "ten to fifteen percent"[20] deviation is acceptable. Yet the Smith Committee study found the difference between market value and assessed value of some properties as large as "seventy-two percent."[21] There were wide variations in the assessment-sales ratio within a particular municipality and significant variations among municipalities. It was clear that municipalities consciously attempted to assess different types of property at different fractions of their true market value. The Report noted assessments at generally higher percentages of market value for apartments and business properties than private residences and generally lower ratios on vacant land than on land and buildings. The higher assessments generally corresponded with those property types in which the property tax would be less visible to the owner because of the many other cost components involved in the property. "In short, there was considerable evidence of discrimination in prevailing assessing practice against apartments and in favour of single-family residences, as well as

substantial undervaluation of land in all classes of property."[22] The Committee concluded that in the years under study, the municipalities assessed dwellings other than apartments "with a degree of inaccuracy that deserved public censure."[23]

The worse offender, the City of Toronto, had an average assessment value that was "thirty-one percent"[24] of the sale price of a property. Toronto's assessments had been "manipulated for various reasons since the early 1900s."[25] For instance, many owners of houses that formerly belonged to World War I veterans continued to receive tax rebates with low assessments even after extensive renovations fifty years later. The 'partial graded exemption was given to 45,600 houses in the City of Toronto in 1921 to allow poorer families to buy homes. Many of those houses were occupied by middle- and upper-income families, who benefited unnecessarily from the exemption.

The Ontario Government was also a culprit in these inaccurate assessments. The province produced and encouraged the use by local assessment departments of an assessment manual with values related to the year 1940. Inevitably, older single-family homes received preferential assessment rates as compared with assessments on homes in new subdivisions. This "blatant inequity"[26] discriminated between properties similar in size and value. Another particular distortion in the system was in the area of farm properties. The assessed value of this class of property was "consistently low"[27] across the province. The fact that farmers are an extremely sensitive group politically may have partly accounted for this finding.

## Smith Proposals for Reform

When the Smith Committee completed its study, it proposed reforms with a goal of making the tax system more equitable. The only way to ensure more equitable treatment within and between classes of property, it felt, was through the adoption of market-value assessment of property. The Smith Committee recommended that the province play a larger role in assessing real property; that all real property first be assessed at 100 percent of its actual value; then, that residential property be taxed on the basis of 70 percent of this assessment; and that business property be taxed on 50 percent of the assessed value. One of the big advantages of current market value assessment would be that property owners could better judge the reasonableness of their assessments. "Not only would MVA eliminate the variations in taxes paid on properties of the same type - residential, multi-residential, commercial or industrial - it would also erase inequities among the classes that had arisen since the 1940s as different kinds of properties appreciated at different rates."[28] With an unchanged tax system, the first official study of the effects of a move to MVA in the Region of Niagara shows that there would be "an increase of 7 percent in taxes on residences, an increase of 46 percent in taxes on farms, and a decrease of 20 percent on industries."[29] But the sharp rise in assessments would be balanced by a proportionate drop in mill rates to raise the same amount of revenue. Thus, the allocation of the burden, not the size of the burden would change.

Following the Smith Committee recommendations, the provincial government took over the function of assessing real property from the municipalities completely. Of course, there was a storm of protests from municipal politicians over the loss of local autonomy. Yet the declared commitment to adopt the MVA base for property taxes was even more difficult. Committees were appointed to study the implications of the reform in greater detail, especially, to analyze the shifts in the tax burden that would result. An unofficial study by the real estate firm of Picken and Mason showed that the burden would be shifted to residences and away from industry. The Mississauga area that had implemented MVA bore out the study's conclusion. Another finding was that a correction of assessment inequities through taxation of all properties at market value would decrease taxes on distilleries by "about 20 percent."[30] Realty assessments on distilleries tended to be about 70 percent higher than on similar properties occupied by other businesses.

Yet local politicians, not taxpayers, seemed to be the loudest critics of the proposed system. The Metro Tenants Association was warned by Alderman J. Sewell that the average tax for homeowners would increase by more than 50 percent and "only the wealthy developers will be able to own houses in downtown Toronto."[31] The Mayor of Sudbury, J. Fabbro, said the province's proposal was "bound to create more slums"[32] and many people would have to sell their properties. Toronto Controller M. Campbell tried to arouse public opinion on the issue, as "the only way for the city to obtain a receptive hearing from the provincial

government."[33] City planning officials in Toronto noted that altering the tax burden could make significant changes to the character of neighbourhoods; "such as Don Vale, Sussex-Ulster and the Annex area."[34]

Another major opponent to the reforms was the farm lobby. The Ontario Federation of Agriculture urged farmers to withhold payment of school taxes in 1970 to protest against current methods of assessment. It argued that the tax should be based on ability to pay. Instead, it was estimated that farmers paid between "10 and 20 percent of their net income"[35] on school taxes alone, because the taxes were based on their land holdings. Still, the Globe and Mail reported that "tax payments in municipalities (were) on schedule despite grumbles"[36] that year.

Budget Paper E: 1976

After several postponements, the April 1976 Budget speech outlined a system within which MVA could be implemented. The main points of the government proposals were as follows:

"1. Residences in Ontario, collectively, will bear a reduced share of property taxes. [This would be achieved by taxing residences on 50% of their market value assessment.]

2. Residential property will be redefined to include only residences and a reasonable amount of land.

3. The present practice of levying different mill rates on residential and commercial properties will be discontinued.

4. Farmland, farm buildings, managed forests and farm residences will be assessed at market value. Farmland, farm buildings and managed forests will be taxed at 100 percent of market value and the taxes will be paid by

the Province. Farm residences will be taxed as all other residences at 50 percent of market value and the taxes will be paid by the owner. There will be provision to recover taxes paid by the Province if the property changes use.

5. All real property used for the purpose of a business including government administrative facilities will be subject to an additional assessment of 50 percent of market value for business taxes.

6. All public property except residences will be subject to payments in lieu of taxes equal to full taxes at 100 percent of market value. Public residences will be subject to payments in lieu of taxes equivalent to full taxes at 50 percent of market value. Public utilities will be subject to business assessment at 50 percent of market value.

7. As is the present case, churches, cemeteries and property held in trust for a band or body of Indians will be exempt. All other presently exempt property will be taxed at 100 percent of market value, except residences which will be taxed at 50 percent of market value.

8. A uniform method of phasing-in the new tax system over a period of up to five years will be available to prevent abrupt tax changes.

9. Assessment rolls will be returned and enumeration will be performed every two years to coincide with local government elections.

10. Assessment on provincial government property will be pooled and assigned between the public and separate elementary schools in the same proportion as the taxable assessment assigned by the owners and occupants of residences.

11. Costs shared among municipalities will be shared on the basis of the assessment on which taxes and payments in lieu of taxes are based.

12. Where assessment is to be used to determine the grant to be paid to a municipality, the assessment used will be the assessment on which taxes and payments in lieu of taxes are based.

13. The provisions of The Assessment Act will apply to the assessment of all real property in Ontario, including areas without municipal organization.

14. Public bodies which receive provincial grants, such as school boards, will be allowed to include their property tax payments as allowable expenses for grant purposes."[37]

The Budget Paper E system would apply one standard mill rate to differing percentages of a property's market value, depending on the property's classification. Thus, it would be a classified property tax with residences to be taxed at 50 percent of market value and all other property at 100 percent of market value. The tax on farm property was to be paid by the province entirely.

These proposals regarding farms went further than the earlier reports "by essentially removing the requirement that these taxes be recovered if the property changed use."[38] However, under the existing legislation the entire farm was taxed at the lower residential mill rate and owners received a 50% rebate from the provincial government. Moreover, the assessment was based on the value of the farm (including farmland, farm buildings and farm residences) to a person "whose principal occupation was farming, an amount which is generally much less than the normal market value..."[39] The outcome of the changes then, would be that farms would "continue to bear extremely low property taxes relative to other property."[40] It should also be noted that all business property was to be assessed at 150 percent of market value for business tax purposes. In an Ontario Economic Council study, Bird and Slack point out that "it is very hard to think of any economic rationale for this."[41] In effect, the proposed classified property tax offered "explicit assessment

favouritism to residential taxpayers under a reformed MVA system."[42] The rationale behind the business property tax proposals in Budget Paper E was an attempt to cope with transitional inequities that would occur during the implementation of an MVA system. Studies showed that the net effect of the new system would still be a slight decline in total business taxes. It would be unwise politically to be seen to be giving business a break at the individual resident taxpayer's expense. Therefore, there was nothing to do but to impose a surcharge on business in the form of the business tax based on a property assessment.

The Blair Commission was appointed to study these proposals. Although the Commission received 900 submissions, it was noted that "the principles of tax reform did not seem to be received with either interest or concern by the general populace."[43] The important consideration for all of those who challenged the reforms was the change in tax liabilities that would occur. What was made clear during the hearings was the fact that short-run effects of the legislative changes were more significant to the public and further, that politicians were extremely sensitive to these short-run effects.

It was said that the group most worried about tax reform was Ontario's developers. Unimproved land would be taxed at 100 percent of its market value under the new proposals. The Urban Development Institute predicted higher housing costs rising as a result of what might be a "6 to 8-fold"[44] increase in suburban land costs. The small- to medium-sized retail merchants also complained to the Blair Commission. The Retail Merchants

Association of Canada protested that under the new system, owners of fewer than 4 stores could be paying "75 percent more business tax."[45] The tourist industry was "not thrilled" by the reforms since many of the businesses in this sector were "close to the line of economic viability."[46] Land-intensive business like golf courses were profoundly affected by the proposals. One owner suggested that golf courses should be granted tax concession "by virtue of their oxygen-generating capacity."[47] Finally, the Minister of Agriculture said that farmers were "generally against the tax reform."[48] This was because they were benefiting by the existing weak assessment practices.

Each of these groups did have a legitimate interest in the system of property taxation and it is argued that each of these groups could have been accommodated within the MVA system through special relief measures. When the Blair commission released its report in March 1977, it generally supported the 1976 Budget proposals but it did recommend certain concessions to these groups. The Commission suggested that under the MVA system, the province should pay 90 percent of farmers' property taxes and that golf courses be allowed a 50 percent deferment on their payment of taxes to the municipality. The Blair commission felt that the interests of special groups could be met without compromising away the MVA system.

The Financial Post outlined implications of the Blair Recommendations.[49] The property tax burden would shift from residences to commercial, industrial and business property. Older houses in urban core municipalities would pay more property

tax where the levy on apartments would decrease and there were fewer businesses to share the heavier load. The decrease in taxes on apartment buildings would probably not mean a corresponding decrease in the rental payments of apartment dwellers since the property tax is such a small cost component of apartment buildings. The cost of the property tax is included with many other elements in the rent cheque of apartment dwellers and so, is unnoticed by most renters anyway. On the other hand, owners of single-family residences would pay more tax and therefore, feel the effects of the new system immediately. On top of this, these homeowners would have the extra burden startlingly brought to their attention since they paid the tax in one lump sum.

If, as F.A. Clayton argues, the subjective tax burden determines public resistance to the tax, public resistance would be stronger where the tax becomes more evident. The shifts that would occur as a result of the proposed reforms would, in effect, make a less visible levy much more prominent. This of course, would increase the subjective tax burden (a taxpayer's personal evaluation of the reduction in his welfare that is caused by the objective tax burden) and so, increase public resistance to it. Since property taxes are linked with local governments, municipal politicians seemed to feel that they would have to bear the adverse political consequences of this resistance. Alderman J. Sewell has said that any attempt by the province to convert to a universal MVA system would be purely political because "the Tories have a lot of support in the suburbs and not so much in

the city."[50] Local representatives were not particularly concerned with equity in the tax system. An increase in a taxpayer's subjective property tax burden would be a negative reflection on them. They could not afford this short-term effect of the proposed reforms and so, they fought them.

The "Alternative System"

"Both opposition parties in the Legislature attacked the Blair Report. The N.D.P. said it raised more questions than it answered and the Liberals said it 'tinkered' with municipal financing rather than improving it."[51] By 1976, the Government had studied the property tax five times since 1967 but could not implement any reforms. The provincial treasurer Darcy McKeough said, "We need to have a great deal more information and public response before we can proceed."[52] The key here was public response. The Progressive Conservatives held a minority government at this time and, soon to be facing an election, they could not afford to deal with such a "potentially explosive issue."[53]

Finally in January 1978, a revised White Paper on Taxation introduced the "Alternative System." The treasurer, Darcy McKeough announced: "Everybody including myself, is scared stiff. But everybody, including myself, knows it has to be done."[54] The Alternative Systems softened the rigours of a MVA system in order to minimize the impact of the tax shifts even further than had the Blair Commission. All properties were to be

assessed at market value but different mill rates were assigned to certain classes; for instance, business assessment could range from 130 percent to 240 percent of market value instead of the uniform 150 percent proposed in the 1976 Budget. The Alternative System also returned to the original idea that the province would pay 100 percent of farm taxes, instead of the farmers.

Michael Denny wrote that these proposals were "politically admirable on the surface"[55] in that voters as residents received a cut in taxes and the politically important farmers retained and extended the substantial tax benefits they had always received. The increases seemed to fall mainly on vacant lands, the federal government and Ontario Hydro. "But the simple total picture masks very different results once smaller geographical areas are considered."[56] The proposals would actually cut distillery property taxes by "$3 million,"[57] the tax on small businesses would eventually rise, the tax on apartment buildings would decrease but not the rent of apartment dwellers and municipal politicians would have special guidelines imposed on them in this regard. These results were clearly uncovered by the Provincial-Local Government Committee set up to analyze the Alternative System proposals. The most significant aspect of the Committee's work was "the publication of fairly extensive data on the tax shifts that would result from the various reform proposals."[58]

It is interesting to note that the local politicians in Metropolitan Toronto were, again, strong opponents of the reforms despite an O.E.C. study released at about this time concluding that "the problems resulting from (increases in property taxes)

do not seem too great."[59] Toronto City Council urged that municipalities be allowed to set their own mill rates. A Toronto Alderman felt that the reforms "exacerbated undesirable trends"[60] in the economy and that the timing of the tax shift from renters to owners was wrong. It was reported that most homeowners elsewhere in Ontario would benefit by the proposed tax change, "but not in Metro."[61] The end-result of these reform proposals is indicative of Metropolitan Toronto's influence in the province.

The Ontario Secondary School Teachers Federation was also opposed to the reforms. In a series of articles prepared for the Globe and Mail, it was argued that McKeough's policies would have dangerous long-term effects. The Federation's concern was that since the funding for education depended on the property assessments within the community, under the MVA system certain areas would be desperately short-changed. If the properties within a community were assessed at much higher levels, that community would receive less governmental assistance. It was felt that certain areas would be receiving less assistance under the new assessment system and the "casualties (would be) municipal councils and school boards."[62] Then, school boards would not be able to maintain existing programmes because of the "increased inequalities in delivery of services among municipalities."[63] The group argued that equality of educational opportunity in Ontario was at stake in the reform debates.

On the other hand, the existing system resulted in Windsor's civic government and school boards receiving about "$13

million"[64] less in provincial grants in 1976 than it would have under a MVA system. Sarnia had paid an extra $1.3 million in that year as its share of the costs of the Lambton County Board of Education. Thus, "the issues involved (were) much more complex than the debate ... acknowledged."[65] Matters to be considered included "effects on neighbourhoods, on investment, on local autonomy, on provincial-municipal transfers, and on the municipal fiscal system in general."[66]

When the Provincial-Local Government Committee reported in April 1978, the difficulty of implementing meaningful reforms became even more clear. For instance, despite the fact that business taxes to be imposed would lessen the decrease in property taxes that would be received by the commercial and industrial sectors, distillers, industrial and financial businesses would still obtain substantial decreases under the new system. So, the Committee recommended increasing the flat business tax rate from the 50 percent recommended by the Blair Commission to 65 percent. This recommendation was rejected immediately because the government could not afford to offend the political important retail and commercial property group. The Canadian Property Tax Agents Association protested that, rather than introducing a more equitable system, the proposals would produce "a combined total of $392 million in excess of a true market value demand"[67] from the commercial and industrial sectors in Ontario. On the basis of 1976 tax data, it was estimated that commercial and industrial properties represented 27.3 percent of total market value while paying 42.9 percent of the total

property tax; therefore, $245.6 million in excess property and business taxes were paid with the existing system. Under the proposed system, commerce and industry would be paying "49 percent"[68] of the total tax burden. The group warned that such discrimination against them would result in higher prices for consumers and increased difficulty for businesses in international competition.

In still another attempt to reduce the impact of the tax shift, the Committee recommended allowing Metro Toronto up to 3 years to deviate from the proposed tax on 50 and 75 percent of the market value of single and multiple dwelling residences. This would not really have been a major change from the Alternative System but might make the reforms more politically palatable in Toronto. It is clear then, that the provincial government officials were aware of the concerns of the municipality where the inequities were the greatest and were willing to attempt to meet these concerns.

## Failure of the MVA Reform

The Provincial-Local Government Committee reported in April 1978. In June of that year, the provincial government announced that the property tax reforms would be indefinitely postponed. An interesting incident occurred in California which may have influenced the government's decision. N.D.P. leader Michael Cassidy said, "that event was in McKeough's mind, as well as the 'difficult politics' of the issue in Ontario."[69]

In the first week of June, California taxpayers had passed the notorious Proposition 13. It was a "revolt that cut their property taxes from 2 1/2 to 1 percent of assessed value."[70] P. Brimelow of the Financial Post felt that groups in education, the media and the civil service (who wanted to block a much more flexible tax-limitation proposal) had been behind Proposition 13 using "ruthless and inflammatory" propaganda. This 'anti-tax feeling' was thought to have spread to Canada, influencing McKeough's decision to postpone the property tax reform measures. "Middle-income homeowners formed the backbone of the California revolt," [71] reported Los Angeles' Bureau of Municipal Research. Metropolitan Toronto's B.M.R. felt that the same elements of discontent were present here and this was confirmed by a report by Goldfarb Consultants. A root cause of taxpayer discontent in California was the current market value assessment system. Therefore, Mckeough had good reason to be cautious in implementing such a reform.

Individual taxpayers were concerned mainly with their own particular circumstances and because of the traditional system in Ontario, these varied greatly. Consequently, there was little organized response to the proposals from residents. While local politicians fought the reforms, "the response from business was 'meagre' and from individual taxpayers it was 'less than overhwhelming'."[72] This public apathy provided no incentive to the provincial government to continue with the reforms.

Another factor obstructing the property tax reform was the election promise by the Progressive Conservatives to balance the

provincial budget. The government would have needed an extra "$400 million to pay municipalities in lieu of property taxes on provincially owned property and other tax credits demanded by local governments,"[73] had the reforms been implemented. But more importantly, Mr. McKeough told municipal leaders: "The Government is not prepared to go to the people on this issue ... I point out to you that we are a minority Government."[74] The Progressive Conservatives could not afford the reforms in terms of money or in terms of votes. There could be no upset of voters with underassessed properties at such a time.

The Municipal Liaison Committee, representing 500 Ontario cities and towns, responded in a brief to the Cabinet. This group said that Ontario's failure to reform the property tax system could be disastrous. It was pointed out that after nine years of governmental studies, commercial and industrial property owners were "wise to the inequities in the system."[75] There had been a great move by taxpayers to appeal assessments and win tax reductions. As a result, the group warned, the tax base was being eroded and eventually municipal services, such as, police and fire protection might have to be cut back. Windsor's Mayor B. Weeks reported that service cuts had "already been taking place" in that city. North York Controller B. Greene called the failure to implement the reforms a "gutless decision of a minority government."[76]

There was no consensus even among local politicians on what kind of reforms would have been feasible. The Globe and Mail reported that: "Politicians reactions ... range(d) from

jubilation to disgust and disappointment."[77] P. Gillis of the assessment division of the Revenue Ministry, saw Metro Toronto as the "major stumbling block in the planned move to MVA."[78] The inequities in Toronto were so extreme that any change in the tax system would produce huge shifts in the tax burden in that area. Representatives of other municipalities argued that there could be gradual phase-ins to minimize the impact of any tax increases on Metro property owners. But "fifteen municipal politicians who analyzed the tax reform proposals came up with ten dissenting opinions."[79]

Provincial officials blamed local politicians entirely for the failure of the reform proposals. Treasurer Darcy McKeough concluded that for local politicians, tax equity was not worth "the cost (of) decreased grants or an increased portion of shared costs or incurring the wrath of those taxpayers who . (paid) less than their fair share in taxes."[80] An Ontario government official admitted that the decision to shelve the reforms was based on the "$400 million cost to the province, public indifference and the response of local politicians who feared ballot box disapproval."[81]

End Result

After being a primary cause of the failure to implement the MVA system, municipal politicians met their nemesis in s.86(b) (now s.63(1)) of The Assessment Act. This measure allowed assessors to change the value of assessments if it is believed

that the assessed value is "inequitable with respect to the assessment of similar real property in the vicinity." It would equalize taxes within a community only and could not deal with inequities between classes of property. However, this measure would only be implemented in municipalities that requested it. This "put the head of every municipal politician on the chopping block,"[82] the N.D.P. protested.

While Revenue Minister Lorne Maeck denied that this piece of legislation shifted the province's responsibilities to the municipalities, he said that "he was not going to stand by and allow inequities to remain when there is a way we can help partially."[83] His successor, George Ashe was less diplomatic. Ashe said: "This is one area where we're saying, 'Fine, big daddy won't force the decision on you. You go ahead and ask us to implement s.86 and we'll be pleased to do it."[84] Obviously, the property tax reform had become a political hot potato. It was true that "any major reform of Ontario's moth-eaten assessment system would be political suicide."[85]

With this partial reform, some of the more obvious inconsistencies in the tax system could be leveled out and Metro Toronto would be safe from any change, or at least the onus would be on the city politicians to institute changes. Despite George Ashe's complaint that "it isn't fair to let one municipality stand in the way of reform for everyone else,"[86] Metropolitan Toronto would not allow such changes in its tax system. Toronto Mayor Art Eggleton indicated that under s.86 (now s.63(1)) "there would be at least a 10 percent transfer of the burden from higher-

income households to lower-income households, from north of Bloor Street to south of Bloor Street ... It would cause massive problems in Toronto, in part because of tax shifts from over-assessed houses on the city's fringes - particularly in such traditionally posh areas as Rosedale and Forest Hill - to rejuvenated under-assessed neighbourhoods downtown."[87] A recent study by the Metropolitan Toronto Bureau of Municipal Research concluded that the MVA system now used in many Ontario towns "would play havoc in Metro."[88]

The MVA system is appealing where there can be a uniform ratio of property taxes to market values. John Bossons argues that the basis for the assumption that there can be such a uniform ratio "across broad groupings of property taxes,"[89] is very weak. In his view, the goal of fairness is much easier to ensure between properties of a similar classification than between different types of properties. Thus, any tax reform would have to be much more limited than the foregoing proposals. Moreover, Bossons feels that: "To assume that market value of real property owned by an individual or corporation is a good proxy for ability to pay is naive and dangerous."[90] It is not clear then, whether the proposed universal market value assessment reform would have been a good thing or not.

## Conclusion

In the process of reforming real property taxes in Ontario, the players most seriously involved were not the taxpayers. In fact, the public seemed quite indifferent to a change in the system. This may be largely due to the fact that it is "unclear who bears the burden of property taxes."[91] Invisible inequities continue because consumers share the burden with businesses and tenants share it with homeowners. Also, special phase-in measures could have been implemented to accommodate certain groups that would be hurt by the reforms.

The voices that were heard the most during the reform debates were those of local politicians. Certain municipalities stood to lose money from the reforms but this was not the issue. What was really at stake for this group was a loss of power. The existing assessment system allowed municipal leaders to decide who would bear the burden of property taxes within their jurisdiction. They could also decide how much of a burden property taxes would be in the community. This type of influence was not easy to give up. With a universal MVA system across the province, it would be impossible to continue an implicit programme of favouritism within any specific area.

The MVA debates can be seen as contests between the locals and the provincial government to control public funds. When the game was over, Revenue Minister L. Maeck admitted that any "move to universal tax reform is doubtful until a more flexible scheme for different municipal 'tax habits'"[92] could be hatched. The

municipal officials had clearly won a victory at that point, perhaps at the expense of a loss of revenue since increased awareness of inequities by taxpayers made continued overassessment difficult. The victory won by municipal officials was one for local autonomy but whether this was ultimately beneficial to individual taxpayers remains an open issue.

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# 8. INTEGRATION OF PERSONAL AND CORPORATE INCOME TAXES

## Philosophy

There are two schools of thought regarding the taxation of corporate income, the integration and the segregation school. The integration approach would pierce the corporate veil and allocate shares of undistributed corporate income to shareholders. Proponents of this approach argue that all taxes are ultimately paid by individuals and not corporate bodies and the fact that corporations do not have a taxable capacity of their own must be recognized. Otherwise, the system discriminates against those who receive their income through the corporate form of business organization by taxing the same income flow twice. Moreover, it is argued that taxing corporations separately will distort patterns of resource allocation by making unincorporated sectors of the economy, where rates of return are higher, more attractive to investors.

Those arguing for the segregation approach to corporate income tax see the corporation as a separate legal entity. It is felt to have economic and political power in its own right and a tax on the corporation limits this power. Canada and most other countries follow this approach to taxation and impose a separate tax on corporate earnings, regardless of the personal income tax paid on dividends received by resident shareholders. Firstly, this system gives the government a large and convenient source of revenue. Secondly, "in law and in practice"[1] the corporation is

regarded as separate from its owners. The payment of dividends and the retention of earnings are controlled for the most part by paid managers and not shareholders, who actually have little control over their corporations. Thus, segregation proponents see the corporation as a taxpayer unto itself.

A large part of the reason for the Canadian approach is the influence of our neighbour to the south. "The importance of the U.S. tax system in shaping the Canadian tax system shows up not only with respect to the form in which integration can be achieved but also with respect to the rate of the corporate income tax."[2] Because Canada has a small open economy, it is linked with the U.S. Any corporate tax system introduced must take the American shareholder and his U.S. tax position into account.

## History of Dividend Taxation

> "In the popular mind while some corporations are associated with certain prominent personalities who may or may not really own any considerable part of the stock, corporations are in general supposed to possess an entity apart from the persons who compose them, and that taxes paid by them are therefore not taken from the pockets of individuals, but are taken from an abstraction whose character is open to suspicion. This illusion is similar in kind to that which is prevalent about the taxation of land, the idea in both cases being that a tax may be paid by a thing and not by a person."[3]

This statement expressed the philosophical reservations on the taxation of corporations felt by the economist James Mavor in

1900. This fear of 'double taxation' has been fully realized by now. That is, corporate income is taxed in the hands of companies and taxed again the hands of individual shareholders because of the dividends they receive. The dividend tax credit is an attempt to lessen this effect for residents. However, in the beginning of the twentieth century great pains were taken by governments in Canada to avoid this result altogether. Dividends from corporations were entirely exempt from the municipal income tax in Ontario. In 1905, the Ontario Commission on Railway Taxation noted with approval: "When the income of a corporation is made subject to taxation the dividend income of private individuals from stock held in such corporations is exempt from taxation, in other words, the income is assessed to the corporation, not to the shareholder."[4]

In 1917, the first Dominion Income War Tax Act did not tax dividend income. There was a simple, flat 4 percent tax rate for both individuals and corporations, with a modest graduated surtax for individuals. This way there was no double taxation of corporate profits. Yet in 1925 this situation ended permanently. The tax system was changed to a graduated rate structure, the rates for corporations and individuals were differentiated and during the shuffle, the exemption of dividends in the hands of shareholders was dropped.

It has been argued that the tax treatment of dividends was changed only because of the mechanical difficulties involved in giving an exemption from a graduated tax. In the debates on the Bill in 1926 though, the government defended the measure on the

basis that "it had been made in response to general requests from the public that earned income be taxed lower than unearned income."[5] In principle, it is difficult to see why capital-source income should be treated differently than labour-source income by the tax system. Ostensibly though, the change in taxation was made because of a perceived difference in the two types of income. However, it might be argued that the change was a crude attempt to tax wealth. Because dividend income accrues, for the most part, to wealthy Canadians, they would be detrimentally affected the most by such a change. Taxing corporate-source income at higher rates would make this form of investment less attractive to resident investors, but the rich revenue source that would open up for the government and the political appeal of the change were irresistable. It was, as James Mavor had said: "In the popular mind...taxes paid by them (corporations)...are taken from an abstraction whose character is open to suspicion."[6] Thereafter, the corporation would be regarded as a separate entity for tax purposes and dividends became fully taxable on the individual shareholders.

Predictably, the Canadian business community was upset by this measure. A representative of the Canadian Manufacturers' Association, in reviewing the 1926 Budget before the Canadian Tax Conference of the Citizens' Research Institute, said:

> "The most drastic change was that which cancelled the exemption from normal tax of dividends from Canadian companies, the new provision requiring shareholders in Canadian companies to pay to the full on their dividends, regardless of the fact that the companies themselves have already paid income tax."

> "The Dominion government is to be commended for the reductions in taxation made in the budgets of 1926 and 1927 but it is regretted that dividends paid by the manufacturing companies already assessed in corporation taxes must still pay a second time in personal incomes. It is hoped that the government will see fit to abolish double taxation in the next budget."[7]

Even in 1928, the C.M.A. continued its protest at the Tax Conference. The spokesman declared: "The question of the taxation of industrial dividends of companies which have already been taxed, and which has been the subject of much criticism remains still unsolved, but we look for some adjustment next session."[8]

Prime Minister R.B. Bennett attempted to revive integration in the 1931 Budget. He proposed exempting a maximum of $10,000 of dividend income from Canadian corporations from income tax to the extent of one-half the income of the taxpayer. "It was unnecessary for the taxpayer to pay a second tax on his dividends because it has already been paid by the company"[9] he argued. The opposition in the House accused the Prime Minister of favouring his own personal position and that of his friends by these proposals. The criticisms were so violent that the plan was dropped. The plan was not dropped because it lacked merit, rather, it was too politically damaging for the government to implement.

The issue was revived slightly in 1940 when the Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Commission) noted that the taxation of corporate profits when they were earned by the company and again when they were

distributed to shareholders "was undesirable and should be repealed."[10] Again after the war, in 1946, a Royal Commission on Taxation headed by Mr. Justice Ives concluded that: "the double taxation of their profits coupled with high estate taxes was effectively destroying small businesses."[11]

The government finally took action in response to these studies in 1949. The basis for the current corporate-shareholder tax system was introduced. The Minister of Finance Douglas Abbott announced:

> "So severe is the application of our present law in such cases that many such businesses (private companies) have been driven into a great variety of extremely complicated and cumbersome devices to secure legal avoidance of the excessive tax burden to which they are now potentially liable. As a result, we are losing revenue to which we think the public treasury has a justifiable claim."[12]
>
> "...It seems to me that under a system of private enterprise which depends for its existence on a steady flow of venture capital we cannot afford to neglect the implication of this defect in our tax system...as a result of the low corporate rate of 10 percent coupled with the 10 percent credit, this budget removes completely double taxation on small business where profits are less than $10,000."[13]

To start with, the two-rate corporate tax system was begun whereby the first $10,000 of annual income would be taxed at 10 percent and any excess income would be taxed at 33 percent. The other major change in the corporate tax structure was that individual shareholders resident in Canada could, in computing tax payable for a taxation year, deduct 10 percent of all dividends received in the year from taxable corporations.

The dividend tax credit would completely offset corporate income tax for closely-held corporations and for widely-held corporation shareholders the credit would partially offset the tax and serve as an incentive to Canadians to invest in Canadian corporations. It was designed to "unlock the built-up corporate surplus that had been earned but never paid out to shareholders"[14] because of the double taxation of corporate income. "Dividends" meant also "deemed dividends" and interest on income debentures. "A deemed dividend is a corporate distribution deemed to have been made out of undistributed income on hand upon the winding-up, discontinuance or reorganization of a corporate business, the redemption, acquisition or reduction of common shares, the conversion of common shares into preference shares or corporate debt, or the payment of a stock dividend".[15]

The dividend tax credit was then increased to 20 percent in 1953 to correspond to changes in the corporation tax. However, it was a very imperfect mechanism for achieving the results ostensibly desired by the government. The 20 percent tax credit was most valuable to the taxpayer having the highest proportion of dividends to total income. "For example, a taxpayer with $200,000 invested at an average dividend yield of 5 percent would ordinarily pay tax at (the existing) rates of about $1,870, plus old age security tax of $240. The 20 percent tax credit of $2,000 for such a taxpayer would entirely offset the income tax otherwise payable, with the result that only the old age security tax (would be) paid in respect of the dividend income of $10,000."[16]

Richard Bird has written that from a equity point of view the dividend tax credit device has two defects: "1) it favours the upper income group and 2) it affords partial relief only."[17] At the Canadian Tax Foundation's Annual Conference in 1960, Harvey Perry said: "My impression is that the main effect of the dividend tax credit has been to give tax relief on dividends from equities to people who would likely have invested in equities in any event. Certainly it has not had the expected effect of stimulating the use of equity finance in industry."[18] Yet a modified version of the system remains in place today despite the years of tax reform. Thus, we must conclude that something other than the efficacy of the measure as an investment incentive, the declared objective of the measure, keeps it in place.

## The Carter Commission

When the Carter Commission was established, the state of the law was such that there was ample opportunity for abuse by Canadian resident corporations and shareholders. The problem was that there were so many special provisions for certain circumstances and special types of corporations that the complexity and confusion inevitably left gaps in the tax legislation.

First of all, personal corporations that did not carry on an active business but were simply investment holding companies controlled by an individual or family were not taxed. Their

income was attributed to the shareholders by the Income Tax Act. Organizations within the section 69 definition of "investment companies" paid tax on income from all sources at a rate of 21 percent. This was entirely offset by the shareholder's tax credit. Non-resident-owned investment corporations paid a 15 percent tax. Foreign business corporations, credit unions and most co-operatives were not taxed at all.

Generally, Canadian resident corporations paid a 21 percent income tax on the first $35,000 of annual profit. In Ontario and Quebec though, the rate was 23 percent. Annual profits in excess of this amount were taxed at a rate of 50 percent (52 percent in Ontario and Quebec). This split rate of tax was designed to favour small businesses. However, it was easy for large corporations to abuse this provision by splitting business among corporations. This occurred despite the many legislative provisions designed to prevent this type of tax avoidance.

With regard to dividends received by a corporation from "a) a taxable corporation, or b) a non-resident corporation more than 25 percent of the issued voting shares of which belong to the receiving corporation, or c) a more than 25 percent-owned foreign business corporation,"[19] they were and still are deductible in computing the taxable income of the corporation shareholder. These exempt intercorporate dividends though, are added to the retained earnings of the receiving corporation and so, usually tax is finally payable by individual shareholders of the recipient corporation. The intercorporate credit merely eases the multiple taxation of corporate income as it flows from the original source to the ultimate shareholder.

Because the existing dividend tax credit system gave only partial relief to resident shareholders for the corporate income tax that had been paid, many and varied 'surplus stripping' techniques had been developed by tax planners and investors. These were legal but artificial means by which built-up post-tax earnings of corporations could be extracted by shareholders either tax-free or at nominal rates. By 1963 it had become impossible for the government to close each loophole in the Act with a separate piece of legislation and ensure that some amount of tax was paid on corporate distributions. In that year's Budget, as a last-ditch effort, the notorious s.138A(1) of the Income Tax Act was introduced. This new subsection allowed ministerial discretion in determining the extent of the taxability of corporate distributions. The provision allowed the Minister to levy tax on certain amounts received by shareholders as a result of transactions which, in the opinion of the Minister, had as one of their purposes a substantial reduction of assets of the corporation in such a way as to avoid tax on distributions.

It is a measure of the government's desperation in the fight against 'surplus stripping' that such power was given to the Minister. Many argued that the basic rule, 'no taxation without legislation', had been broken. At the Canadian Tax Foundation's Annual Conference in 1963, G. Tamaki said: "It is hoped that the (Carter) Commission will be able to come forth with a solution which will recognize the special problems of taxes on dividend income and which will eliminate the need for complex, restrictive

or arbitrary rules of taxation or for the abdication of the power to tax to the untrammelled discretion - however benevolent - of the Minister of National Revenue or his officers."[20]

The Royal Commission on Taxation, set up to recommend improvements in the tax system, began to hear submissions on double taxation and the dividend tax credit in April, 1963. It was clear by then that the existing dividend tax credit system was inadequate to unlock the built-up retained earnings of corporations. Of course, the Canadian Manufacturers' Association took the same stand it had taken in 1926. The group recommended that corporate income tax be abolished or that resident shareholders should pay no personal income tax on dividends received; these were the only methods by which double taxation could be eliminated. The Montreal and Toronto Stock Exchanges recommended that dividends should be received tax-free. The Canadian Pulp and Paper Association wanted the corporation tax to be treated as a deduction at source on personal income derived from dividends. Anaconda American Brass Ltd. submitted that, "there is no logical reason for levying a tax on corporation income, as such, since the concept of 'ability to pay' has no relevance to a corporation."[21] The briefs of the Canadian Labour Congress and the United Electrical, Radio and Machine Workers of America presented other criticisms of the existing system. They felt that the dividend tax credit: (1) probably had not induced Canadians to invest in taxable Canadian corporations, and (2) had no basis in theory when the corporation tax was shifted forward in prices, to be borne by consumers, rather than in less dividend income, to be borne by the shareholders.

Despite the many alternatives that were suggested to the Commission, it was understood that the Canadian government was limited in the steps it could take to improve the taxation of corporate source income. Firstly, the revenue loss caused by any change in the corporate income tax system had to be considered. Secondly, it was necessary to be certain that changes in the tax system would not simply result in money being transferred from the Canadian treasury to foreign treasuries. Analysts realized that a majority of investors in Canada were Americans. Removing the corporation income tax would leave corporations with more money for distribution to foreign shareholders. The increase in dividend income would then be taxed in the hands of the American shareholders by the American government. Thus, the tax revenue on corporate income presently brought in by the tax on corporations would simply be transferred to the American government. On the other hand, under the existing system the American government allowed its taxpayers a credit for foreign tax paid on income. This was transferring money from the American treasury to Canada.

> "What this means is that the corporate rate, the form of integration between the corporate income tax and the personal tax, and the top rate of the income tax schedule are all in a sense set by the American tax system. The principal reason for these substantial limits on the policy autonomy of the federal government, of course, rests in the underlying assumption of the Carter Report - and it is surely a correct assumption - that there is in essence a unified capital market in North America."[22]

The Report of the Carter Commission described the system taxing corporate source income in Canada in 1966:

"1. The corporation is taxed on its income computed in accordance with the ordinary rules for determining business or property income. It pays dividends out of after-tax income.

2. Corporations receiving dividends from other taxable Canadian corporations or from certain foreign companies may, with specified limitations, exclude such dividends from taxable income.

3. The individual resident shareholder includes dividends in income and is allowed a credit against his total tax liability equal to 20 per cent of the dividends paid to him by taxable resident corporations.

4. The individual shareholder ordinarily does not include in income gains on shares nor does he deduct losses on shares.

5. Dividends paid to non-residents are subject to a with-holding tax at rates of either 10 per cent or 15 per cent (in specified circumstances).

Thus, the corporate flow of income is taxed at two levels and at two different times. The corporation tax is levied when the income is earned, and the shareholder is taxed when he receives a distribution from the corporation. The second event, if it occurs at all, may occur many years after the income is earned at the corporate level. Most of the problems in this area have arisen because the shareholder can delay the imposition of the second tax, and perhaps even arrange his affairs so that he need not pay it at all."[25]

Further in the Report, the Commission summarized the defects of the dividend tax credit system:

"1. The failure to tax share gains has made it possible for shareholders to avoid or reduce personal income tax while realizing the retained earnings of corporations through:

a) the sale of the shares of widely held corporations at prices that capitalized the retained earnings, or by

b) surplus-stripping, or by taking advantage of the relieving provisions introduced to assist share-holders of closely held corporations.

2. The tax system has been strongly biased toward the retention of earnings by corporations with the result that the Canadian capital market is thinner and less developed than would otherwise be the case.

3. A corporation that relies on the issuance of new shares to finance its expansion, and hence has to maintain an adequate cash dividend to avoid a reduction in the price of its shares, has been at a distinct tax disadvantage.

4. Shareholders controlling closely held corporations have had a tax advantage over other shareholders because they could limit the dividends of the corporations so as to minimize personal taxes.

5. It has been extremely difficult to prevent the abuse of the low rate of tax on the first $50,000 of corporate income by the splitting of a high income corporation into a number of non-associated corporations each of which is taxed at the low rate. Section 138A(2) may be more effective than prior attempts to meet the problem, but it is arbitrary and is uncertain in its impact.

6. In an attempt to restrict the avoidance of personal tax on retained earnings, the legislation has become increasingly complex and arbitrary, with the result that some legitimate business transactions have been deterred.

7. In particular, section 138A creates uncertainty, and the 'designated surplus' provisions are often a barrier to mergers and reorganizations that have a useful business purpose.

All of these specific defects are quite apart from the arguments made against the present corporation tax on the ground that it is inequitable because it represents double taxation."[24]

Along with a tax on capital gains, the Commission proposed full integration of personal and corporate income taxes. In other words, the Commission wanted the company to be treated as an intermediary which only existed for the purpose of earning profits. These profits would then be taxed in the hands of the

true owners, the shareholders, at their personal rates of tax. The 'gross-up and credit' system proposed would operate so that after-tax profits of a corporation would be allocated pro rata to resident shareholders who would 'gross-up' dividends, plus the tax paid; bring this amount into income and receive credit for 100 per cent of the tax paid by the corporation. The Commission's objective was "to encourage Canadian resident investors to buy equities by means of tax structure that (would) not worsen the current position of non-resident shareholders."[25]

Assuming that the corporate tax had not already been shifted in higher prices, lower wages or lower materials prices, there is no doubt that full integration would result in a more equitable tax system. Yet equity has rarely been a sufficient motive to implement a reform in taxation. The reason for the change was supposed to be the investment incentive that would be available to residents. However, one of the big problems with the Carter proposals was the fact that "the favourable effects on investment in fixed capital of full integration are dependent on (among other things) the residence of the marginal investors - a most uncertain matter."[26] "Given the presence of non-resident marginal buyers (in the Canadian economy), residents would still obtain the increases in net corporate source income...but because the improvements in after-tax income would not be capitalized in higher share prices, the reduction in the user cost of capital would not occur. The consequence would simply be a windfall tax saving."[27] Therefore, it seems that full integration might not stimulate the use of equity finance in Canadian industry at all.

On top of this, credit is only given for corporate tax paid. This, in effect, offsets all corporate tax incentives.

## The White Paper

The White Paper on Tax Reform was introduced by the Minister of Finance, E.J. Benson, in response to the Carter Recommendations. The White Paper proposals allowed full integration for closely-held corporations but only half-integration for widely held corporations. Thus, all corporate tax on dividends would be withheld and credited against personal liability in closely held corporations but in the case of widely held corporations, although the tax would be withheld in the same way, only half of the tax would be credited to individual shareholders. Compared with the existing system, there would be greater progressivity in the taxation of dividend income. However, it would not be as equitable as the Carter system.

In the White Paper, the government asserted that the relationships between corporations and shareholders differed substantially, depending on the size of the corporation. "There is little likelihood of the shareholder of a public corporation feeling that he owns the assets of the corporation, and little likelihood of the corporation paying out several years earnings in one year. Further, the shareholder in a public corporation is to a considerable extent unaware of the operation of the interaction of the personal and corporate tax rates: he

considers that his income from his share is his dividend..."[28] The proposed distinction between widely held and closely held corporations in the tax rules, the government thought, would reflect these different relationships.

In addition, the distinction was to reflect the fact that generally, "the closely held corporation competes with proprietorships, partnerships, and, of course, with other closely held corporations, while the public corporation competes with other public corporations, both Canadian and foreign."[29] The objective of the proposals was to put the two types of corporations as nearly as possible in the same tax position as their competitors. Canadian widely-held corporations competed in a league where it was "natural for the competition to bear corporate income tax,"[30] and the government felt that some part of the tax was shifted to consumers in the prices charged by the corporation for goods and services. "For this reason"[31] the government did not want to give shareholders full credit for the corporate tax paid by those corporations.

The system of partial credit for widely held corporation shareholders also provided a rough balance with the proposals to tax 50 per cent of the gains on the sale of shares. It was conceded that the taxpayer in a lower rate bracket would be better off receiving his income in dividends than in the form of capital gains because the proposed system was less balanced in his case. However, the government declared: "This probably coincides with their natural inclination to buy into well-established Canadian corporations where their investment is less at risk."[32]

A Discussion Paper for the Institute for Economic Research noted that political considerations "play a large role in the differentiation between the two sets of proposals."[33] The fact was that the Carter Commission, although concerned with such practical aspects as revenue requirements, did not have the "real political pressure to which an elected government must pay close attention."[34] Yet by differentiating the tax treatment of the two types of business organizations the White Paper proposals were encouraging methods of tax avoidance for businesses that the Carter Commission had hoped to foreclose.

The submissions to the Commons Committee on the White Paper clearly pointed out the weaknesses of the proposals. The 'arbitrary' distinction between closely held corporations and widely held corporations was felt to be discriminatory among companies in similar economic circumstances. The assumption that closely held corporations competed only with unincorporated businesses was "completely erroneous" and "naive" (Brandon, Manitoba, Chamber of Commerce). The International Nickel Company of Canada detailed its objections to the White Paper proposals under five headings: "(1) discrimination against growth, (2) reduced attractiveness of resource shares, (3) unattractiveness for foreign expansion, (4) complications for inter-corporate dividends, and (5) compliance difficulties."[35]

The brief of the Government of Ontario summarized many of the objections to the White Paper proposals:

> "The integration provisions would discriminate against shareholders of Canadian-based international companies, Canadian-owned steel

> companies, and other high-productivity companies with insufficient creditable tax and would also increase the cost of raising equity capital in Canada for steel and multi-national companies. Further, such provisions would shift Canadian equity investment out of the growth, technology, and risk-oriented companies into conservative, high-dividend companies, resulting in less Canadian participation in growth industries and in the exploitation of new technologies which will propel economic growth in the 1970s and 1980s.
>
> "Since the bulk of corporation taxes is borne by the consumers in the form of higher prices, it is not equitable that such taxes be credited back to the shareholders. Further, to be workable, dividend integration requires reduction of the top marginal rate of income tax to 50 per cent, giving high-income earners an unwarranted reduction in their income taxes. It is recommended that separate taxation of corporations and their shareholders be retained.
>
> "The White Paper proposals on dividend integration and complex distinctions among types of corporations are rejected. Retaining the present well-tested system of taxing corporations and their shareholders is recommended so as to avoid the serious problems which would arise under the proposed system. A reasonable capital gains tax not requiring elaborate compensating offsets in other tax areas would be practicable within the present structure."[56]

A majority of the submissions clearly preferred revisions to the existing dividend tax credit system over the White Paper proposals. However, it must be remembered that submissions in response to the White Paper that were made by corporations were made by corporate executives. The managers of corporations do not have the same interests as the owner-shareholders. Yet they control the resources of the corporation and increased corporate reliance on capital markets that would result from a tax system that encouraged high payouts of corporate profits which would

weaken that control. Therefore, even though the shareholders of INCO might have gained by the proposals, INCO officially opposed the proposals. The shareholders would not have been sufficiently organized to forward their interests by presenting a brief to the Commons Committee. In most public companies they are not a cohesive group that can act together. The corporation's 'viewpoint' is consequently expressed by its managers and not its owners.

In response to the criticisms of the White Paper proposals, the Commons Committee recommended further modifications to the integration concept proposed by the Carter Commission.[37] The degree of integration had to be generally related to the level of capital gains taxation in order for the tax system not to interfere with the market system. That is, so as not to make speculative transactions more attractive to investors because of advantageous tax consequences. The Commons Committee recommended half inclusion of capital gains in income and half integration for Canadian residents with respect to all Canadian corporations resident in Canada, whether widely or closely held. Still, an exemption for $50,000 of taxable income of closely held corporations was to be allowed as a tax break for small businesses.

After a comparison of integration obtainable through the existing dividend tax credit (where a Canadian shareholder was allowed to reduce his taxable income by 20 per cent of the dividend received) or an integration credit system using a gross-up and credit method of calculation, the Committee concluded that

the integrated system of allowing credit at the personal tax level for Canadian tax paid on Canadian corporate source income of Canadian residents was more equitable and worth the increased complexity. For instance, under the existing system a taxpayer receiving $300 worth of dividend income must go through the mechanics illustrated in the following table:[38]

| | Marginal Rate of the Taxpayer | | |
|---|---|---|---|
| | 25% | 40% | 60% |
| Dividend received | $300 | $300 | $300 |
| Income tax before credit | $ 75 | $120 | $180 |
| Less dividend tax credit - 20% | 60 | 60 | 60 |
| Income tax payable | $ 15 | $ 60 | $120 |
| After-tax dividend | $285 | $240 | $180 |

The following table illustrates the mechanics of the system proposed by the Commons Committee.

| | Marginal Rate of the Taxpayer | | |
|---|---|---|---|
| | 25% | 40% | 60% |
| Dividend received | $300 | $300 | $300 |
| Add dividend tax credit - 33 1/3% | 100 | 100 | 100 |
| Taxable amount | $400 | $400 | $400 |
| Income tax before credit | $100 | $160 | $240 |
| Less dividend tax credit - 33 1/3% | 100 | 100 | 100 |
| Income tax payable | $ 0 | $ 60 | $140 |
| After-tax dividend | $300 | $240 | $160 |

The final table shows the after-tax income for shareholders with marginal rates ranging between 25 per cent and 60 per cent on $300 dividend, received under the old and new system:

Dividend: $300

| Marginal Rate | After-Tax Income | |
|---|---|---|
| | New | Old |
| 25% | $300 | $285 |
| 30% | 280 | 270 |
| 40% | 240 | 240 |
| 50% | 200 | 210 |
| 60% | 160 | 180 |

In another submission to the federal government, the Ontario Government emphasized that the "progressive erosion of the integration concept to try to meet anticipated problems, many of which would still remain under the Commons Committee form of integration should be abandoned as part of national tax reform."[39] The provincial governments realized that any form of integration would mean more federal centralization of the tax system and a consequent loss of power in the tax system for them. The Ontario government submitted three papers on tax reform to the federal government.[40] In the final paper, it listed as one of the reasons for rejecting integration, the fact that integration would require "excessive" federal "control of the personal and corporate tax systems, hence (it) would preclude the necessary scope for the provinces to use the income tax fields."[41]

1971 Tax Reform Legislation

The Bill resulting from the many public debates was tabled in 1971. In it the dividend tax credit was increased from 20 per cent to 33-1/3 per cent and the 'grossed-up' dividend was to be included in income before the tax calculation. The new 'gross-up and credit' system required the amount of the dividend to be included in income and then the federal and provincial authorities would permit a credit to be taken against the taxes payable equal to the extra one-third of the dividend included in income. This meant that the dividend tax credit would be more important to lower-income groups because it would decline in significance as taxable income rose. The higher a taxpayer's marginal rate, the smaller the absolute dollar benefit he would obtain. However, how many lower-income groups receive dividend income? The progressivity of the DTC seems to be merely cosmetic.

"Canada's rejection of full integration in favour of a form of dividend relief that allows tax preferences to benefit shareholders in a rather haphazard and inequitable way is usually viewed with disappointment by public finance experts...But though the Canadian approach is imperfect, it is clearly a substantial step forward from the earlier system that allowed a 20 per cent credit for dividends-received but without gross-up."[42] Still, if what may have been the underlying objective of this tax measure is considered, the dividend tax credit system may be a success. As well as the political decision process that ensues, explicit

consideration of who benefits and who pays for this measure points to the real objective of the dividend tax credit.

## Conclusion

In 1979 the estimated revenue cost of the dividend tax credit was "$934 million, federal and provincial."[43] Yet in that same year how much more revenue was collected because of the corporate income tax (and how much of this amount came out of the pocket of foreigners?)? If the dividend tax credit is just a windfall tax saving, the only benefits to the economy "result from increases in the disposable income of resident investors."[44] There are clearly more direct tax measures that could be taken to achieve this result. The Carter Commission had hoped to encourage Canadian investment with its proposals. Yet it seems likely that Harvey Perry's comments in 1960 could be repeated today for the current system: "My impression is that the main effect of the dividend tax credit has been to give tax relief on dividends from equities to people who would likely have invested in equities in any event. Certainly it has <u>not</u> had the expected effect of stimulating the use of equity finance in industry."[45] Therefore, it seems likely that this objective has not been reached by the dividend tax credit. If the elimination of double taxation was desired, then surely the Carter proposal for full integration of corporate and personal income was the answer. But the government found it impossible to implement this proposed measure.

Because of the large amounts of revenue that are generated for the government through the taxation of corporations and perhaps because the corporation is still viewed as "an abstraction whose character is open to suspicion,"[46] perhaps the elimination of double taxation of corporate income is not really desirable. A possible reason for the existence of the dividend tax credit then is that it is a palliative for the resident investor. In 1949, the Finance Minister spoke of the variety of "extremely complicated and cumbersome devices"[47] small businesses resorted to in order to avoid the tax burden on corporate distributions. He also spoke of the revenue loss to the public treasury which resulted. In the 1960s, the many surplus-stripping devices in small companies and the capitalization of retained earnings in large companies through the sale of shares at prices that accounted for unpaid dividends (so that dividend income would take the form of untaxed capital gains) meant that again, investors were avoiding the second tax on corporate distributions and the government was losing revenue, despite the existing DTC system.

Some analysts began to advocate a flat rate withholding tax on dividends and 'hang' the principle of equity in the tax system.

> "Study of the past experience in the history of corporate surplus taxation in Canada has shown us, regardless of our views about progressive taxation as a general proposition, that this problem could not really be solved by a rigid adherence to the theory of progressive tax rates on distributions. There had, in fact, been such an erosion of the principle in this area of the tax system that the principle no longer had any real practical meaning as a revenue producer."[48]

The government first attempted to close each loophole individually, then tried allowing ministerial discretion in a sweeping provision to counter the gaps in the legislation. The Carter Commission's proposal to treat income from all sources equally would have solved these problems because no form of income would have been preferable to another for tax purposes. However, the Canadian government realized that it would either have to lose taxing power over the income gained by foreigners on Canadian investments or treat foreigners so discriminatorily under the tax system as to be in violation of its treaty obligations. Indeed, the current dividend tax credit system was one of the problems that held up the ratification of the new Canada-U.S. Tax Treaty.

Today, "residents hold 55 per cent of outstanding shares"[49] and so, we can assume that the American investor is still a very significant element in the Canadian capital market. Therefore, in many ways the dividend tax credit system with its gross-up and credit method is the best solution in that it does "not affect corporate investment, since it is, in effect, a windfall gain to resident shareholders."[50] The DTC probably does make the corporate income tax more palatable to resident shareholders though. The DTC allows the government to continue to tax foreign shareholders indirectly through the corporate income tax and again through the withholding tax on dividend income.

The dividend tax credit has not been and should no longer be thought of as an investment incentive. There are much better methods (for instance investment tax credits) within the tax

system for providing incentives. With the DTC system, the Canadian government can tax corporate distributions to American shareholders without seeming to discriminate against them and the American government will credit its taxpayers with the foreign tax paid. At the same time, it can be argued that the DTC takes from the poor and gives to the rich. If the corporation income tax is shifted to consumers as a crude sales tax or to employees through lower wages, then to credit the dividend income of shareholders with the tax paid is highly inequitable. The windfall tax gain is then paid for by the general public without regard to ability to pay. However, perhaps the DTC is needed to balance the corporate tax and whoever else pays for this measure, the biggest burden is on foreigners.

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## 9. THE INTRODUCTION OF PARTIAL INDEXATION OF THE PERSONAL INCOME TAX

It is generally accepted that real income is a better measure of taxable capacity and 'ability to pay' than nominal income. A rise in money income that matches a rise in price levels is an illusory increase and should not be considered extra taxable income. This means that changes in the price level should be allowed for in determining taxable income. If the personal income tax system in Canada does not adjust for inflation, the consequences for the individual taxpayer are two-fold.

Firstly and most importantly, tax allowances (including exemption and deductions) fixed in nominal terms would result in taxable incomes rising at a faster rate than gross incomes before deduction of allowances. Thus, there would be an increase in real tax liability for all taxpayers. Secondly, because of Canada's progressive income tax schedules, a taxpayer's liability increases faster than his taxable income does. "The more progressive the rate structure, that is, the narrower the income brackets and the wider the tax rate increment, the more real tax liability increases as inflation pushes money incomes."[1]

> "To illustrate how inflation increases tax burdens and erodes disposable income, consider the case of an individual with $5,000 gross income in 1973. Suppose his gross income increases at the rate of inflation between 1974 and 1980. By 1980 his gross income will have increased to about $8,700 (assuming 6.6 percent inflation in 1974, sustained at 6 percent thereafter). With no change to the 1973 tax structure, his 1980 income tax would be $1,044 as compared to $449 in 1973. Thus, his real disposable income would decline to 94 percent of its level in 1978."[2]

Empirical studies have shown that inflation has a dramatic effect on real family incomes and "hardest hit are low-income, multi-child families."[3] A study by George Vukelich on the effect of inflation on real tax rates demonstrated clearly that "when price levels are not constant, 'a great deal of change occurs automatically in personal income tax rates'."[4] Vukelich concluded: "Analyzing the intertemporal rate structure in real terms has indicated that inflation has the effect of rapidly increasing real rates of taxation. The effect is particularly evident for families with a large number of exemptions."[5] In his proposal to adjust tax rates for inflation, John Bossons showed that "tax increases resulting from inflation are highest not at incomes where the marginal tax rates are highest, but rather at incomes where marginal tax rates increase most rapidly. Such inflation tax increases thus fall most heavily on middle-income taxpayers and on low-income taxpayers with incomes just below exemption level."[6]

Moreover, inflation provides automatic increases in the financing for the public sector. If the tax structure remains unchanged, as a larger proportion of taxpayers move into higher marginal rate brackets, the proportion of national income absorbed by the personal income tax tends to rise. In his report, Vukelich questioned the legitimacy of a tax system that did not account for inflation.

> "Have tax policymakers consciously taken these changes (in price levels) into account in developing discretionary changes? Are they aware of the substantial upward shift in the tax structure that has occurred over the years 1954 to 1970? It has been suggested that since the public has accepted taxing

> nominal income without voluble protest, the government need not alter its policy in this regard. Resentment, it has been argued, tends to focus on those taxes that people are most aware of. Are taxpayers so unaware? It is all too easy for the changes in the tax structure resulting from inflation to escape the notice of taxpayers. The illusion can result from the real world situation that "increases in real tax rates resulting from purely nominal influences have been inextricably confused with the increases in payments which are a normal consequence of upward secular trend in national income even in the absence of price increases." Thus inflation may be viewed as a form of taxation which to the government has all the psychological benefits of being indirect. Without the necessity of winning parliamentary approval and without overtly raising nominal tax rates, the government can obtain a rising share of personal incomes so long as it maintains a steady rate of inflation. But at what cost? Surely inflation is a clumsy way of raising taxes, with surprising and unintended effects on burden distribution."[7]

For the taxpayer, the best protection against inflation seems to be indexation of the tax system, to automatically adjust for inflation rates. "Indexing is hardly a new concept; indeed, attempts to adjust to inflation are as old as inflation itself. In England, the payment of tithes was once linked to an average of wheat, barely and oats prices; Oxford and Cambridge Universities rented their land for payments in grain, thus ensuring against price fluctuations. And as early as the mid-1700's, a form of indexing was used in the Massachusetts Colony. Since World War I, more than thirty countries have relied at one time or another on at least limited indexing, and four of these -- Brazil, Chile, Israel and Uruguay -- have implemented very complex programs."[8]

Opponents of indexation list three main disadvantages of such a system. Firstly, it might discourage the fight against inflation, especially for politicians who would have "very little

incentive to introduce policy measures aimed at controlling the rate of inflation."[9] Secondly, a universal indexation system would build inflation into the economic system automatically. Indexing would make Canada's economy particularly vulnerable to any exogenous shock (for instance, a foreign war that cut off supplies of a primary resource) that would start a circle of increasing price levels pressuring wage levels to increase, which would in turn push price levels upward. Another objection to indexation is that it would interfere with the free market system of our economy. The forces of demand and supply theoretically achieve the most economical use of scarce resources by raising their relative prices. It is argued that if nominal incomes were automatically adjusted, producers and consumers would have less incentive to economize by changing their buying patterns. Consequently, "inflationary pressures would become even stronger and scarce resources scarcer."[10] The primary reason behind introducing a system of indexation though, is equity. It would give across-the-board protection against inflation's worst effects. Indexation would protect the poor, the weak and the elderly.

## The Tax Reform Era

However, to the question of whether the tax structure should be designed to allow explicitly for inflation, the Carter Commission responded that "no attempt should be made to adjust automatically for changes in the purchasing power of money."[11]

This can be explained by the fact that, in the post-war era, inflation was a relatively insignificant factor in the economy until about 1965. Between 1952 and 1965, the inflation level averaged approximately "1.5 percent per annum."[12] Thus, the distorting impact of inflation on the income tax structure did not seem to be of paramount importance. The commissioners felt that subjecting the tax structure to periodic scrutiny in light of increases in the consumer price index would be sufficient to offset any deterioration in the economic positions of taxpayers.

The Carter Commission espoused the traditional point of view. They felt that the automatic stabilizers that were built into the existing tax system would be weakened, "if not destroyed,"[13] if taxes were not based on current dollar income. Further, the commissioners concluded that adjustments for increases in the consumer price index would be "extremely complex if they were confined to some forms of income and not to others."[14] They gave the example of the government adjusting the income tax of a shareholder to take account of increases in the market value of equities that had resulted only from rising prices but not reducing the taxes of persons receiving contractual payments that did not increase with inflation. "It should not be the function of the tax system to attempt to relieve only some segments of the population from the effects of inflation."[15]

In reviewing the Report of the Royal Commission on Taxation, Richard Musgrave, then Professor of Public Finance at Harvard University, regretted that no explicit provisions were recommended for adjusting taxes for price changes.

> "I must, however, record uneasiness with the Report's lack of concern for distinguishing inflationary from real capital gains. Surely, an equitable concept of income must be in real terms and, ideally, all income would be adjusted accordingly. Thus, inflationary gains in equity prices would not be taxed, real gains of debtors would be taxed and real losses of creditors would be allowed for."[16]

It is indicative of the conventional attitude of those times that the White Paper on Tax Reform, in responding to the Carter proposals, did not even mention the term "inflation." This led a speaker at the Canadian Tax Foundation's Annual Conference to comment that "the relation between inflation and taxation is sufficiently timely and important that we could have expected some direct comments on this subject."[17] He went on to say that although the Carter Commission could plead that this issue was not within its terms of reference, Finance Minister Benson had no such excuse since inflation was becoming a significant problem in the Canadian economy. The speaker, Robert M. Clark, composed a verse for the occasion:

THE WHITE PAPER

"I had a dream some weeks ago,
When all the silent stars were still.
One autumn evening late at night,
Three men descended Parliament Hill.
One, Benson, puffed a pipe and smiled
And I knew at once by sight.
A PR man was on his left,
Another walking on his right.
Said they: when you are criticized
And captious critics seek to bite,
Invoke ability to pay,
A goddess she, uphold her light!

Don't mention one topic contentious,
Lest it mar your image bright.
No, no, not sex inflation!
Keep this topic out of sight.
And Benson in my dream did smile,
For he knew what he had in mind.
But I asked then, as you would too,
Will taxpayers be in a bind?"[18]

When inflation-induced increases in real tax liabilities begin to result in substantial reductions in real disposable income, "possible distortions of horizontal equity resulting from a partial price-adjustment process and .. a possible reduction in built-in stability are of a rather secondary order of importance in relation to the over-riding need for the prevention of the unlegislated increase in real tax liabilities which the inflation process occasions."[19] It soon became clear that the makers of the Canadian tax system could no longer avoid the inflation issue.

Various techniques for automatically offsetting inflation have been suggested. Amotz Morag first proposed converting the taxpayer's income to real terms to avoid annual adjustments to the system in 1965.[20] Milton Friedman advocated indexation in the United States. He said, "Indexing per se will not, in my opinion, do anything to reduce inflation. But what it will do will be to make it easier to terminate our inflation. It will make it easier by reducing the incentive for government to inflate and by making the withdrawal pains from inflation less severe."[21]

In limited attempts to respond to inflation, the Canadian government had begun to implement partial indexing in some areas. For instance, old age pensions and other forms of transfer

payments were linked to the consumer price index. In the private sector, wage settlements frequently included annual cost of living increases. Pressure for protection against inflation began to grow in other areas.

John Helliwell suggested an alternative system that included a device to tax capital gains in real terms in 1970. He was supported by Robert Clark at the annual conference of the Canadian Tax Foundation in that year. The Helliwell proposal advocated automatic annual adjustments to the exemptions or tax credits, the standard deduction, the boundaries of the income tax brackets and the maximum dollar deduction for employee expenses. At the same Conference, John Bossons suggested that tax credits be introduced. This was in line with recommendations of the Carter Commission. He recommended that these credits be adjusted for inflation annually. He also favoured adjusting the brackets for inflation as Helliwell had proposed.

Helliwell had argued that measures removing inequities resulting from inflation overrode any consequent reduction in the government's ability to get political support for a set of anti-inflationary policies. Commenting on the Benson White Paper, he said: "Inflation is just a clumsy way of raising tax rates, assuming that we have a progressive tax system. To gather support from an anti-inflationary campaign by tying an increase in effective tax rates to the rate of inflation is surely not something the government ought to be willing to do."[22]

World events since 1965 had clearly had a profound impact on the conventional attitude toward inflation and taxes that was

illustrated by the Carter Report. Acceleration in the rate of inflation resulted in the consumer price index in 1973 being 37 percent above its 1965 level. "In the context of this sustained surge in prices, the equity and distributive implications of failing to adjust the personal income tax for the effects of inflation (had) been dramatized."[23] Following from this, the traditional Canadian macroeconomic policy of combating inflation had been relatively ineffectual. By 1973, fiscal policy restrictions had "raised the unemployment rate 60 percent above 1965 levels"[24] without countering the inflationary surge. The perceived stabilizing properties of the tax system then, seemed to lack force. A study completed for the Economic Council of Canada soon after the Carter Report was published showed how difficult it might be to control inflation in the near future. The study concluded: "Under the conditions postulated above, the economy is almost certain to experience some degree of inflation no matter how expansionary or how restrictive monetary and fiscal policy happens to be."[25] This conclusion was primarily based on the finding that foreign (particularly American) wages and prices had a very strong influence on the stability of Canadian consumer prices and wages. In comparison, Canadian fiscal policy was a relatively ineffectual force against instability.

John Helliwell outlined five factors that compounded the problems with a tax system that did not account for inflation at the Annual Conference of the Canadian Tax Foundation in 1972.

1) The Rate of Inflation: A high annual rate of inflation would mean that taxes deferred were actually

taxes avoided. For instance, the Brazilian 40 percent inflation rate meant that if a tax was deferred for two years, it was two-thirds avoided.

2) The Type of Income Being Assessed: The type of income being assessed was a factor in that "the problems of measuring income accurately are greatest in situations (such as asset transactions) where dollars of different vintages are involved in the calculation."[26] Helliwell was more concerned with measuring capital gains than employment income in relation to the effects of inflation on taxation.

3) Other Flaws in the Tax System and Elsewhere in the Pattern of Income-Distribution: "It would increase inequality of treatment, as between types of income, to remove the inflation factor which leads to over-taxation of capital gains, without also applying regular tax rates to all rather than one-half of capital gains, and making appropriate allowance for the deferral of taxes or tax refunds involved in taxing capital gains and losses on a realization basis rather than on an accrual basis. Thus it would be a mistake to remove inflationary gains from the tax base unless the other two corrections to the base are made at the same time."[27] It can be seen from this that other flaws in the tax system would impact heavily on the relation between inflation and tax burdens.

4) Progressivity of the Tax Structure: The amount of progressivity in the tax structure also impacts on inflation and income tax, since increases in money income lead to higher average and marginal rates of taxation. An example given in the Vukelich study illustrates the interaction of progressivity and inflation:

"A family of two adults and two children, with a single pre-tax income of $7,000 in 1954 would have paid income tax at an average rate of 12.74 percent. If the family's pre-tax income rose between 1954 and 1970 at exactly the same rate as the consumer price index, their average tax would have risen to 16.25 percent."[28]

5) Administrative Problems: The cost of responding to inflation in additional complexity must be less than the benefits obtained from the extra precision and equity in the tax system. The extra accounting required to make timing adjustments to measures of income so that 1961 dollars would not be added to 1971 dollars indiscriminately, was an element that militated against the implementation of a universal system of indexation.

Implementation

During the Budget debates in the House of Commons of May 15, 1972, Robert Stanfield, Leader of the Opposition, proposed a method of insulating effective tax rates from the effects of inflation. He saw indexation as a way to curb government spending. The government would be forced to come to Parliament and ask for an increase in tax rates if it wanted to take a larger share of the real wealth of the country. To avoid this, the government would probably try to restrain its own spending. The Stanfield formula was dismissed by Finance Minister John Turner because "it would erode the financial strength of the federal government and lead to chaos in federal-provincial fiscal negotiations."[29] But the following year, the Budget of 19 February 1973 incorporated equivalent "though not identical"[30] proposals. The Budget's indexing scheme was called "one of the two most important structural changes in the tax system since World War II."[31] (The other important change being the taxation of capital gains.)

In his Budget speech, Turner announced:

> "Beginning in 1974, I propose to introduce the following system. First, in each year an inflation factor would be determined based upon the increase in the Consumer Price Index in an immediately preceding period. Second, in each year the principal exemptions would be increased by this inflation factor. This would include the basic exemption, the marital exemption, the two exemptions for dependents, and the exemptions for the aged and the blind and disabled. Third, every year each of the brackets of taxable income would be adjusted upwards by the inflation factor.

> "For example, if in a particular year, the inflation factor was determined to be 4 percent, then the principal exemptions would each be increased by 4 percent. Similarly, each bracket of taxable income would be adjusted upwards by the same percentage. Thus, the first bracket of taxable income, which is taxed this year at 15 percent, would be raised from $500 to $520. The next bracket, which would be subject to an 18 percent rate, would commence at $520 and would extend to $1,040, and so on right through the tax schedule.
>
> "The indexing of rates and exemptions will produce a tax liability which will no longer erode a person's purchasing power as a result of inflation interacting with the progressive tax system. A person will no longer pay tax at a higher marginal rate simply because inflation swept him up into a higher tax bracket. For a person on a fixed income, the result of indexing would be to reduce his taxes each year if prices rise."[52]

Thus, indexing was to be accomplished by raising tax brackets and increasing personal exemptions each year by an inflation factor based on the consumer price index. The inflation factor for each year would be the ratio of the average "adjusted" consumer price index for the 12-month period ending September 30th immediately before the year in question to the average price index for the 12-month period ending September 30th of the year before that.

Commenting on the new Budget, John Bossons and Thomas Wilson wrote:

> "The indexing procedure proposed by Finance Minister Turner to adjust tax rates for inflation would have two highly beneficial effects. It would eliminate a number of inequities resulting from the way in which inflation now affects effective tax rates. It would at the same time substantially reduce the rate of growth of direct personal tax revenues over the long term, unless such reduction were offset by explicit increases in tax rates. Through so doing, the proposal increases parliamentary control over tax rates.
>
> "These benefits would not be accompanied by any significant costs. Contrary to what has previously

> been assumed, the implementation of the proposed adjustment of tax rates would not reduce the stabilizing properties of the tax system. On the contrary, the Turner proposal would slightly enhance the extent to which the tax system helps to stabilize fluctuations in real output. Moreover, taking into account the indirect effects of inflation-induced tax changes on subsequent price changes, the present contribution of the tax system to "cost-push" inflation would be substantially mitigated. As a result, implementation of the budget proposals to index tax rates should prove beneficial to macroeconomic stability."[33]

As the Finance Minister had said in his Budget speech, this proposal for indexing the personal income tax put Canada "in the vanguard of countries with advanced tax systems."[34] Why had other countries not implemented indexing schemes? For instance, proposals of this nature had been studied in the United States for a long time. In a Conference sponsored, in part, by the Brookings Institution, Vito Tanzi outlined the problems with such adjustment schemes that made them extremely controversial and, so far, impossible to implement in America. "The most important issues any indexing scheme must resolve are the choice of the index to be used for adjusting the rate structure; how to handle indirect taxes; the problem of lags; and the difficulties posed by such hard-to-index incomes as interest payments, capital gains and profits."[35]

In Canada, the consumer price index is used to reflect changes in purchasing power. But Tanzi argued that many studies have shown that "the basket of goods included in this index may not be, and in many cases certainly is not, representative of purchases by typical taxpayers, and possibly by any taxpayers."[36] With regard to indirect taxes, the consumer price index in Canada

is not adjusted for their changes. The usual argument in favour of this is that "if the revenues from indirect taxes are reflected in higher government spending which, presumably increases the welfare of the taxpayers, the index should not reflect the change in indirect taxes."[37] If it is true that higher sales taxes mean an increase in public goods then, on average, real income has not decreased and there is no need to index the personal income tax for the resulting price change. The Canadian government based its decision on the fact that, as a federal country, each of the provinces could change sales taxes independently and adjusting for these changes at the federal level would be at best, extremely difficult and at worst, inequitable. In contrast, under the Danish system "taxes and duties are, to the extent possible, deducted from the prices collected, whereas subsidies provided in order to achieve a general price reduction are added to the prices."[38] This system is more feasible in a non-federal state but it also reflects the position that taxpayers would distinguish between an increase in the consumer price index due to an increase in taxes from one due to other factors.

Other problems involved with indexation are concerned with timing. Especially when inflation is rapid and changing, the time lag between current inflation and the rate reflected in the consumer price index can significantly affect economic stability. Because of the time needed to prepare the income tax forms, the adjustment in rates for each year was based on an index reflecting the average increase in prices that had occurred in

the year before. The use of the 12-month averaging period was designed to minimize the influence of some unusual factor or anomalous effect that would affect an index based on a shorter period excessively. The other time lag though, that between the earning of income and the collection of taxes, is also relevant to indexation but it seems to be a problem inherent in the tax system.

Finally, the contentious issue of dealing with different types of incomes in the tax system becomes particularly significant when an indexing system is implemented. The problem is that different types of incomes are differently affected by inflation. Yet a comprehensive indexing system is generally applied as if all types of income were affected equally. Canada's partial indexation system though, relieved some forms of income but not others. Still, in recent years a system of adjusting the base value of certain capital assets to compensate for illusory capital gains has also been implemented. This shows that the government is still capable of extending indexation despite the severe revenue losses that result. It provides hope that all different types of income can be accommodated in a system of indexation.

A related controversy stems from the fact that the actual amount of relief provided by indexation varies with income levels in a complex way. The Canadian indexing mechanism increased nominal personal exemptions and widened the tax brackets. "Since the dollar magnitudes of both effects depend upon the marginal tax rates, these magnitudes rise discontinuously with total

income, the discontinuities occurring at each taxable income level at which the marginal rate increases."[39] Some critics argued that indexing favours the rich because the dollar saving is greater, the higher the level of income. Clearly though, a comparison of absolute dollar amounts of tax savings is not a valid way to judge the equity of a tax measure. Additional tax incurred by a purely inflationary increase in income will be greater, the higher the marginal rate. Therefore, tax savings for high-income taxpayers would, in absolute terms, be larger in a real-income tax system.

Effects of Indexation

The following table illustrates the effects of indexing for individual taxpayers in 1974:[40]

TAX SAVINGS IN 1974 TO TYPICAL TAXPAYERS AS A CONSEQUENCE OF INDEXING

Based on an indexing factor of 1.066

| Income | Fed. & Prov. Tax Before Indexing | Fed. & Prov. Tax After Indexing | Reduction in Tax | |
|---|---|---|---|---|
| | | | Amount | % |
| $ | $ | $ | $ | % |
| Married Taxpayer -- Two Dependents under age 16 | | | | |
| 4,000 | 7 | 0 | 7 | 100.0 |
| 5,000 | 133 | 72 | 61 | 45.9 |
| 6,000 | 383 | 318 | 65 | 17.0 |
| 7,000 | 646 | 576 | 70 | 10.8 |
| 8,000 | 920 | 846 | 74 | 8.0 |
| 9,000 | 1,198 | 1,120 | 78 | 6.5 |
| 10,000 | 1,498 | 1,409 | 89 | 5.9 |
| 12,000 | 2,129 | 2,021 | 108 | 5.1 |
| 15,000 | 3,145 | 3,014 | 131 | 4.2 |
| 20,000 | 5,198 | 4,966 | 232 | 4.5 |
| 30,000 | 9,699 | 9,374 | 325 | 3.4 |
| 50,000 | 20,138 | 19,651 | 487 | 2.4 |

The provincial tax used in these calculations is the lowest existing provincial rate. Rates of provincial taxes vary from province to province but more than one-half of Canadian taxpayers are subject to the provincial rates used in this table.

Taxpayers are assumed to take the optional standard deduction of $100 and the employment expense deduction of 3% (maximum $150) but the calculations do not take into account any other potential deductions such as child-care expenses or contributions to pension plans or unemployment insurance.

Taxpayers are assumed to be under age 65 and to receive only earned income. All figures are rounded to the nearest whole dollar.

The final column shows the tax savings because of indexing as a percentage of taxes otherwise payable. The figures here indicate that relative tax savings fall as taxable income rises. Thus, indexing has a progressive effect on the tax system because the income brackets are narrower and the marginal rate increase is relatively greater at the low end of the schedule.

Indexing "went into effect on January 1, 1974, with a 6.6 percent adjustment of the whole nominal structure of the personal income tax. For 1975 the increase in exemption levels and in bracket limits due to indexing was 10.1 percent. The absolute tax reductions increase with income and became progressively larger between 1975 and 1975. The percentage reductions in tax liabilities are much greater for smaller incomes than for larger ones, but the ratio of tax reduction to before-tax incomes is similar at most income levels. (This pattern is fairly common in other countries that have indexed the personal income tax.) Indexing reduced income tax revenues about 400 million Canadian dollars in 1974 and $750 million in 1975."[41]

The Province of Ontario studied the major long-run implications for the revenue-generating capacity of the federal and the provincial income tax systems. The findings were tabled in a report by the Ministry of Treasury, Economics and Intergovernmental Affairs.

1) Approximately 4 percent of the provincial personal income tax yield would be lost by Ontario in 1974 because of indexing.
2) With 6 percent inflation sustained from 1974, the estimated federal revenue decrease in Ontario because of the new system was to be approximately $2.8 billion and the Ontario revenue decrease approximately $900 million by 1980.
3) The indexing revenue loss to the federal government, it was estimated, could range from 18 percent (at sustained 5 percent inflation) to about 24 percent (at sustained 8 percent inflation). The reduction in Ontario personal income tax revenues showed the same pattern.
4) The report indicated that the implications for Ontario applied to all the provinces with tax collection agreements and indeed, indexing losses would be relatively larger in the low income provinces. "Thus, the largest proportional losses (were to be) suffered by Newfoundland and New Brunswick."[42]

The provinces seem to have been the biggest losers in the federal indexing system. The reduction in revenue growth

potential of the personal income tax "and related cuts in equalization payments represent a substantial deterioration in their long-run financing position."[43] At the same time, the Ontario government claimed that the federal government, with its surplus financial capacity, could easily absorb this loss. Two senior economists at the Ontario Treasury presented their viewpoint in the Canadian Tax Journal in August, 1974.

> "Indexing, through its cumulative discounting of the historic revenue productivity of the personal income tax, fundamentally alters the balance of the tax structure in Canada. It means that the contribution of the income tax to the total revenue mix will not grow as rapidly as in the past. This blunts the sustained efforts in recent years to improve the overall progressivity of the total tax structure and forces greater reliance at the provincial-municipal level on less equitable tax sources.
>
> "While it is true that individual taxpayers currently enjoy benefits under the personal income tax as a result of indexing, this tax relief could be short-lived.
>
> Reduced revenue elasticity from the dynamic income tax system coupled with demands for enriched public services point to a need for additional government financing, whether in the form of increased income tax rates or a resort to other tax fields."[44] (emphasis added)

However, it must be remembered that increasing tax rates instead of relying on a hidden inflation factor is surely a better way of financing government services. Further, Auld and Miller write in Principles of Public Finance--A Canadian Text that despite the fact that the government's system only partially indexes the income tax for inflation, "it has improved, nevertheless, the overall equity of the tax system...Moreover, a recent study indicates that indexation will increase the progressivity of the tax system."[45]

Still, by 1975 the question in Canada was: "will the tax index plan survive?"[46] D. McGillivrary of the Financial Times of Canada wrote that indexing "is certain to be more sharply questioned now that the federal and provincial governments find their revenues stalled and their expenditures still rising fast. With Mr. Turner out and Mr. Stanfield a lame-duck leader, where will the Stanfield-Turner formula find its defender?"[47] He wondered whether the 'Stanfield-Turner formula' could survive the political demise of Mr. Turner and Mr. Stanfield. A shift to a method of indexing that resulted in a smaller adjustment for inflation in the tax system would give the government a larger part of the real wealth of the nation. Its effect would be the same as that of an increase in taxes. However, "it might have less psychological effect because the indexing system is not as well understood by the public as the tax rates."[48] This kind of change would be very tempting. Beatrice Riddell of the Financial Post felt that "in the present economic environment, and with government revenues as they are, the chances of an early extension of the tax indexing system are not bright."[49] She noted that the contentious issue of whether to index capital gains would probably be put on the back-burner.

Yet this partial indexation system has managed to remain in place. Only in 1983 and 1984 did the government limit indexation to 6 percent and 5 percent respectively but this was part of its comprehensive restraint programme. In addition, the Minister of Finance appointed an Advisory Committee to examine a series of proposals set forth in the Paper for Consultation entitled

Inflation and the Taxation of Personal Investment Income. Thus, indexation has been able to survive and even to extend into other areas of the tax system.

## Conclusion

Canada is in the forefront of countries with advanced tax systems because of the indexation of personal income taxes. This is very laudable reform in that the government sacrificed a very profitable and inconspicuous source of funding in order to levy taxes more fairly. Of course, the indexing system is not universal. However, partial indexation is a step in the right direction. Richard Lipsey writes: "Zero inflation can still be our ideal, but when we fall short, as surely we will, we can rest assured that indexing has banished forever one of inflation's major inequities ... The indexing of income tax is one of our greatest causes for hope."[50]

## END NOTES

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2. Ontario Ministry of Treasury, Economics and Intergovernmental Affairs, "The Dynamic Impact of Indexing the Personal Income Tax", Ontario Tax Studies, No.9 (Staff Paper, January 1974), p.11.

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3. George Vukelich, "The Effects of Inflation on Real Tax Rates", Canadian Tax Journal, XX, 4, (July-August 1972) p.327.

4. Ibid., p.342.

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26. John F. Helliwell, "Inflation and the Income Tax", Twenty-Fourth Tax Conference, 1972, (Toronto: Canadian Tax Foundation, 1973) p.166.

27. Ibid.

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32. Hon. J.N. Turner, Budget Speech, February 19, 1973, (Ottawa: Finance Department, 1973) p.18.

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## 10. THE TREATMENT OF THE INFLATIONARY COMPONENT OF CAPITAL GAINS AND LOSSES

Before the 1960s, the Canadian economy was not highly inflationary. The tax system and the financial system developed in a world very different from today. Current conditions of high and seemingly unpredictable real interest rates and inflation levels, coupled with conventional accounting techniques have been extremely detrimental to Canada's capital market. The effects of inflation-induced tax distortions in particular have had a significant effect on the Canadian economy. "Capital formation has been reduced relative to what it would otherwise have been. As a result, productivity growth also has been reduced and real per capita income has been held down."[1]

John Bossons has outlined some of the economic costs of the way taxes are distorted by inflation. 1) At the level of the individual, reductions in the after-tax real rate of return on savings have probably resulted in a smaller aggregate volume of personal savings. 2) Personal investment has likely been skewed away from taxed investments in the capital markets towards owner-occupied housing and other tax shelters. 3) At the business level, debt-equity ratios have risen. This distortion in business financing has come about because of "the disincentive for personal equity investments caused by the taxation of the inflation component of capital gains."[2] In comparison, real after-tax cost of debt financing has decreased and so, "in effect subsidized corporations that take on increased exposure to financing risk ... and encouraged debt-financed takeovers."[3] 4)

A related phenomenon is the reduction in the overall magnitude of business investment. Bossons argues that this is due to the lack of indexation of the capital cost allowance.

Proposed Solutions

As early as 1969 John Helliwell had suggested that the cost base of an asset be adjusted by an arbitrarily assumed rate of inflation. This, he argued,would make it "possible to remove the purely inflationary component when taxing asset gains, while still measuring the true gain in money terms equivalent to our everyday measurement of current income."[4] This allowance for inflation was to be combined with a scheme for charging interest implicitly through the rate structure on taxes that had accrued since the last date of realization of gains . These adjustments would further the neutrality of the tax system by removing any reason for preferring "capital gains" over "income" and by disregarding illusory capital gains.

At the Canadian Tax Foundation's Annual Conference in 1970, Robert Clark also argued that the government should make explicit provisions for adjustments for price changes in its taxation policies. Owners of specified categories of fixed assets should "be allowed to write up their original cost of these assets in order to allow for price changes, in accordance with an appropriate index."[5] His list of assets whose costs could be adjusted would have included: stocks, bonds and debentures, patents and copyrights, business machinery, buildings and land.

In those early years of inflation, it was still an issue whether "in seeking to reform the income tax system, Parliament (should) consider the risks of likely future inflation, and explicitly allow for this in the structure of the tax."[6] Clark argued that the gains in equity among taxpayers over a period of years would be worth the increased complexity of administration.

The end-result of the debates on the Carter proposals and the Benson White Paper was the 1971 Budget. In it, half of the gains on assets would be brought into income at the time of realization for tax purposes. This was a dramatic change in tax policy. Yet the government felt that it was still possible to pass over the risks of inflation in silence.

As seen in the study on the indexation of the personal income tax, the February 1973 Budget introduced the measures of adjusting tax rates and income brackets for inflation. Inflation was becoming a factor to be reckoned with but its effects on asset prices were still ignored. The following example based on a reasonably typical common stock, illustrates the importance of these effects.[7]

| | In Real Terms (No Inflation) | With Price Inflation of 3% per year |
|---|---|---|
| Price of share at beginning of year | $1,000.00 | $1,000.00 |
| Dividend | 50.00 | 51.50 |
| Capital gain arising from "real" causes | 60.00 | 61.80 |
| Capital gain arising from general price inflation in the absence of other capital gains | -- | 30.00 |
| Price at end of year | 1,060.00 | 1,091.80 |
| Total current income accrued | 110.00 | 143.30 |

Clearly, it can be seen that general price inflation causes the capital gain on the asset to increase by a much larger degree. Here, a 3 percent increase in the consumer price index makes capital gains increase by 53 percent.

Still, the then Minister of Finance John Turner gave four reasons for taking no action with regard to capital gains. He said that "at the time of tax reform, it was decided that only one-half of capital gains would be taxable, partially in recognition that a portion of capital appreciation is a result of inflation, and not of real growth."[8] Further, he justified avoiding the capital gains issue because of government revenue needs; the administrative complications because of depreciation if capital gains were taxed on a real basis and; finally, because tax brackets had already been indexed. Obviously, the indexation of tax brackets is irrelevant to the capital gains issue.

> "... we must distinguish between wage and salary income on the one hand and capital gains on the other. A positive increment to a taxpayer's spending power occurs by the very act of his earning a wage or salary. Hence, under a pure proportional tax, whether or not the purchasing power of the monetary unit were stable, the proportion of real wage and salary income absorbed by the income tax would be constant. But an increment to a taxpayer's spending power (i.e., an "income") does not necessarily follow from the mere act of liquidating an asset. Only an increase in the exchange value of the asset enhances the taxpayer's command over economic goods -- i.e. represents an income flow. If the value of the asset grows merely at the same rate at which prices generally rise, the exchange value of the asset has not increased. If the asset value rises at a lesser rate, the owner has actually suffered a loss in real command over economic goods. Hence, a proportional income tax applied to a nominal capital gains would absorb a larger proportion of real capital gains the higher the general rate of price inflation."[9]

Regarding depreciation, Canadian capital cost allowance would simply require an adjustment to basis and would not be overly complex. The "need for revenue" argument is invalid in that the tax system must be based on legislation and therefore, using inflation instead of legislated rate increases is against fundamental principles of taxation.

As for Mr. Turner's other justification, the fact that capital gains do receive preferential treatment under the current tax system, (being taxed at half rates and only upon realization) M. Bucovetsky has written, "Many existing anomalies in the tax treatment of capital gains are condoned as rough compensation for the fall of general purchasing power."[10] In an article for the Canadian Tax Journal, Bucovetsky analyzed the adequacy of the 50 percent exclusion as compensation for the illusory capital gains that become taxable.

"... consider a hypothetical $100 purchase of the composite common and preferred shares which make up the Statistics Canada Investors' Index. Suppose an investor acquired this portfolio on eight alternative month-end dates spaced at six-month intervals over the period since capital gains have been taxable in Canada, and that each alternative purchase was liquidated after one year (at the prevailing level of the Investors' Index). The result for each alternative is shown in the eight rows of Table 1. The third column shows that in five of the eight transactions the investor would have had a taxable capital gain and in three a deductible loss. In making up the fourth column, relative changes in the Consumer Price Index were used to restate the $100 historical cost in terms of its general purchasing power at the time of sale. Subtracting the inflation-adjusted cost from the realization gives the real gain expressed in terminal dollars. This column shows that on six of the eight transactions the investor would have suffered a real loss. (The only exceptions are shares bought or held on Valuation Day and sold at the end of 1972, and shares held from the end of 1974 to the end of 1975.) Yet with respect to three of the losses he would have paid tax on nominal gains.

Table 1

**Real and Nominal Gains on a One-Year Hold of $100 Purchase of Statistics Canada Composite Investors' Index**

| Date Bought | Date Sold | Nominal Gain (Loss) $ | Real[a] Gain (Loss) $ | Real[b] as % of Nominal |
|---|---|---|---|---|
| V-Day, 22 Dec. 1971 | Dec. 1972 | 22 | 17 | 77 |
| June 1972 | June 1973 | 6 | (3) | (58) |
| Dec. 1972 | Dec. 1973 | (6) | (15) | 262 |
| June 1973 | June 1974 | (13) | (24) | 190 |
| Dec. 1973 | Dec. 1974 | (28) | (41) | 144 |
| June 1974 | June 1975 | 2 | (9) | (496) |
| Dec. 1974 | Dec. 1975 | 12 | 2 | 18 |
| June 1975 | June 1976 | 2 | (5) | (218) |

[a] Cost basis adjusted by change in consumer price index from month of purchase to month of sale.

[b] Percentages of last column are based on "exact" values of nominal and real gains; in columns 3 and 4 these gains are rounded to the nearest dollar.

> "In the last column of Table 1 the real gain or loss is expressed as a percentage of the nominal gain. The hypothesis under test is that the 50 percent inclusion ratio applied to nominal gains (or some other fraction) is a reasonable approximation to realized real gains. If the hypothesis met this test the entries in the last column should be within an acceptable margin of the legislated inclusion ratio. Only one of them--the first--is remotely near 50 percent, and in that case the taxpayer would have been undertaxed on the criterion of full taxation of realized real gains. Rows 3, 4 and 5 imply positive inclusion ratios in excess of 100 percent, but all of them relate to the understatement of real losses rather than the overstatement of real gains. The three implied negative inclusion ratios relate to the cases where a nominal gain was actually a real loss."[11]

Bucovetsky found that since the time when capital gains had been taxable, the 50 percent exclusion was highly inappropriate to a Canadian investor with average luck and skill, as recognition that part of the increase in the share's value was the result of inflation and not of real growth. He concluded that: "When general purchasing power of money is falling full-rate taxation of nominal capital gains in part turns a personal income tax into a capricious wealth tax. But, exclusion from the tax base of an arbitrary portion of the nominal gain is an unacceptable inaccurate and uneven reflection of real erosion due to inflation. Adjusting asset cost basis to reflect the changing value of the monetary unit is the only satisfactory way to distinguish 'capital gains' which genuinely reflect real tax-paying capacity."[12]

Arguably, these preferences in the tax system for capital gains might offset some of the detrimental effects of taxing

inflation-induced gains, but they are extremely crude measures if this is their intended effect. Despite the fact that there were no technical reasons why a complete adjustment of costs bases of assets and liabilities together with imputation of interest on deferred gains could not be implemented, John Bossons noted that "such adjustment would necessitate a more profound change in the structure of the personal income tax than is likely to be contemplated in the near future."[13]

## After P.I.T. Indexation: The Canadian Investment Plan

There was one group though, that would not accept the status quo with regard to the taxation of capital gains. In September 1974, the Investment Dealers Association and the Montreal, Toronto and Vancouver Stock Exchanges submitted a brief to the government outlining a plan that would eventually become the foundation for the 1983 tax measures in this area. This group felt that "existing capital markets in their current state are likely to prove unequal to the burdens these capital requirements will place upon them."[14] They argued that governmental policies would have to provide appropriate incentives to increase the level of savings and investment in Canada. "The erosion in stock prices in North America since 1968, when measured by the broadly based market averages, has been about as severe as the decline beginning in 1929, notably about 75 percent...in real terms (it) has been more severe than in 1929."[15] The Brief went on to say that the existing state of the

capital market negatived one of Canada's objectives: "To provide for greater domestic control of the Canadian economy and its future industrial development by Canadians for Canadians."[16]

The tax proposals of this group were in three parts. 1) They supported a government proposal to exempt $1000 of annual interest income from tax and proposed a similar provision for net dividend income. 2) They wanted capital losses to be deductible against ordinary income. 3) They proposed a Canadian Investment Plan. This plan would provide an incentive for individual Canadians to increase their investments and thus, "increase the depth and flexibility of the Canadian public capital markets."[17] It would also offset what was felt to be "over-institutionalization" of the market. Since each account under the Plan would be individually administered, many securities dealers would provide many opinions for the allocation of the funds within the Plan.

The structure of the Canadian Investment Plan was to be similar to that of Registered Retirement Savings Plans. That is, investments in Qualified Securities would be allowed as deductions from current income. The amount originally invested in the plan would be brought into income in the year of disinvestment. Other amounts withdrawn would be treated as capital gains. Within the Plan, any changes in investment would not be recognized as capital gains although investment income would be taxed currently.

The key to the Canada Investment Plan proposals was the concern felt by investment dealers for the ill effects of capital

gains taxation coupled with inflation on investment in equities. They suggested that the cost levels of securities within the Plan be indexed to overcome the inflation element. A major goal of the Plan would be to provide more funds of capital invested by Canadians in the Canadian public market. Thus, limits were proposed to discourage taxpayers from converting existing portfolios into the new Plan. The group summarized the effects they hoped the Plan would achieve:

> "One of the principal effects sought is the worthwhile increase in the funds invested by Canadians in the Canadian public market. Secondly, this fund can be shifted by the taxpayer among Qualified Investments without a tax penalty, so that market liquidity is enhanced. Thirdly, and very important to improving the functioning of the capital markets, is that the incentive is granted to individual taxpayers so that the increased investment will be by individual investors (thus redressing a bias between individual and institutional investors which has been growing). Fourthly, the C.I.P., unlike most other tax-sheltered plans, accommodates all types of investment objectives of Canadians and is thus likely to attract savings from the broadest possible spectrum of the public. Fifthly, the Plan is comparatively simple to understand and operate and is sufficiently similar to the well-known Registered Retirement Savings Plan to be readily adopted as an additional investment vehicle by the public."[18]

The Government considered the attributes of the C.I.P. and requested supplementary information. The group responded June 12, 1975 on such issues as the type of securities to be included in Qualified Investment, the transferability of C.I.P. Investments, and the proposed eligibility requirements of C.I.P. investors. However, the Finance Minister decided not to go ahead with this plan after all. The only part of the Canada Investment Plan Brief that actually resulted in legislative changes was the endorsement of a previous government proposal to allow a $1000 deduction for investment income of individuals.

It is interesting to note that the debates on the indexation of capital gains had begun to focus almost exclusively on gains from securities investments. Little word was heard of John Helliwell's and Robert Clark's proposals before 1970 to index almost all types of assets. It is highly probable that part of the reason for this is that the only group to keep the issue of indexation before the government was the investment community. Landowners do not seem to have the resources to present their plight to the government in a way that has sufficient impact.

The next thing to be heard from the government on the issue of the indexation of capital gains came in 1980 with the issuance of a Discussion Paper entitled, "A Review of the Taxation of Capital Gains in Canada" by the Department of Finance. Still, no major changes came about as a result of the discussions. Concern with inflation presumably played a role in many tax measures that were adopted however. As mentioned earlier, the $1000 deduction of investment income of individuals was adopted. A two-year write-off for manufacturing and processing equipment was allowed, as well as a 3 percent inventory allowance. Finally, the adoption of the investment tax credit could also be explained, at least in part, as an offset to inflation. These measures were concessions to Canadian industries and investors. They recognized that the tax system, when coupled with inflation, could be stifling the growth of the economy.

The Budget of June 28, 1982

In June 1982, Finance Minister Allan MacEachen issued the first of his Discussion Papers on important tax issues and proposals. The subject was "Inflation and the Taxation of Personal Investment Income." The Government realized that investors were seeking alternative tax shelter opportunities that might yield less return than fully-taxable investments on a pre-tax basis, but more on an after-tax basis because there was no explicit inflation adjustment of investment income. "To remove distortions in the efficient allocation of resources it is necessary to ensure that the tax applies to only the real portion of each incremental dollar of investment return."[19] The Discussion Paper gave an example of increases in the effective rate of tax on the real component of capital gains that was due to the overstatement of capital gains because of inflation.

> "... a common share of a large public corporation may, over a number of years, have a real appreciation of, say, 3 percent per year. In a year when inflation was 5 percent the value of the share might rise from $100 to $108. Only $3 of this increase would be real appreciation; the remaining $5 would be compensation for the decline in the real value of the $100 originally invested. However, under current tax law,one-half of the total nominal gain is taxable. Even after allowing for the benefits of taxing only half of realized capital gains and on a deferred basis, this inflation-induced overstatement of taxable gains can result in an increase in effective tax rates on real capital gains."[20]

The Minister noted that the existing system did have some measures that relieved taxpayers from the full effects of inflation. These were: 1) the exemption from tax on the first $1000 of income from interest, dividends and taxable capital

gains for individuals; 2) R.R.S.P.'s and registered pension plans where contributions are deductible and tax is deferred until the savings are received as pension income (which benefits from the indexation of the personal income tax); 3) savings through the equity in a principal residence are tax-exempt; 4) the deferral of tax until capital gains are realized and the exemption of one-half of capital gains from tax. Still, it was recognized that despite these offsets "on each incremental dollar of investment income, taxpayers face an inappropriately high tax rate."[21]

In the Discussion Paper, possible solutions to the inflation-induced tax distortions were identified. A comprehensive correction of income from investments for tax purposes would include increasing the cost base of investment assets by the rate of inflation in order to calculate capital gains. Interest income would be calculated so as to leave out a part equal to the principal amount of the debt multiplied by the inflation rate. This same calculation would apply to the amount of interest expense borrowers could deduct in computing income. Yet such comprehensive adjustment had very major problems attached to them.

Firstly, design complexity especially for the treatment of debts can make comprehensive corrections undesirable. The Paper discussed the imbalance of reducing deductible interest expense immediately while the corresponding provisions adjusting asset values are, in effect, liquidated over the life of the asset. Correcting for this effect would necessitate the use of complex

provisions. Administrative and enforcement complexities were foreseen because of the changes in accounting required for taxpayers (more sophisticated record-keeping) and increased need for auditing returns by revenue authorities. Thirdly, the inevitable transitional redistribution of tax liabilities could create many windfall gains and losses in the short-run. Minimizing this effect by limiting the adjustments to new assets and liabilities would again, make the system extremely complex. Finally, because a substantial proportion of business investment in Canada is American, any comprehensive adjustments in the Canadian system may simply benefit the U.S. Treasury. American corporations are currently allowed a credit under U.S. tax laws for foreign tax paid. Therefore, any benefits of a lower tax in Canada would be offset by the reduced foreign tax credit. Canadian tax incentives then become transfers of revenue from Canada to foreign treasuries with foreign tax credits allowed to their taxpayers.

The MacEachen Paper then turned to limited indexation schemes. Two possibilities were outlined; interest income, the cost of debt and capital gains on common shares of listed Canadian corporations could be corrected. It was proposed that a system of indexed term deposits and indexed term loans be introduced. Eligible individuals who purchased indexed term deposits would only be subject to tax on real interest income. Eligible borrowers under the indexed term loan scheme would be able to reduce the interest costs on borrowed funds. The main scheme though, was a Registered Shareholders Investment Plan

which would hold all new acquisition of shares of an eligible individual. It was restricted to publicly traded listed shares because of the difficulty of yearly appraisals of market value for other types of assets. The central feature of the R.S.I.P. was the fact that real capital gains were to be taxed on an accrual basis. This was to simplify the Plan's administration and counter the "lock-in effect" of deferring tax until realization. Unlike the original Canada Investment Plan, contributions to the Plan would not be deductible, nor would they be taxable when withdrawn.

Reactions

Generally, the response to Ottawa's Plan seems to have been highly critical. A writer at the Financial Post found the Paper disappointing because comprehensive indexation was rejected for the reason that it was "not feasible at the present time."[22] The fear was that such ad hoc provisions to compensate for the inflation tax burden would bring new distortions into the Canadian financial market, while rectifying others. "But the fact (is) that Canada's tax system has become increasingly piecemeal in the attempt to adjust for inflation. Policymakers will soon have to take a hard look at rationalizing it."[23] Arthur Drache wrote in the Financial Post that "there are a number of drawbacks which will make many potential investors think twice about the idea."[24] He cited the R.S.I.P. investor whose shares increase dramatically in value and who thus, pays

capital gains tax at the end of the year even if he still owns those shares, as "the big loser."

The Toronto Stock Exchange released a brief saying that the Registered Shareholders Investment Plan would "do little to restore investor confidence or resolve the immediate liquidity crisis in Canadian corporations."[25] The T.S.E. was especially critical of taxing capital gains on an accrual basis because of the adverse effects on "investor psychology." A brief from the Canadian Federation of Independent Businesses (the C.F.I.B.) supported this position. The C.F.I.B. based its view on problems of liquidity caused by having to pay for gains not actually received. Instead, the brief suggested repealing the capital gains tax on publicly traded Canadian corporations to create "a clear positive bias"[26] in favour of equity investment. The Toronto Stock Exchange estimated that eliminating the capital gains tax would cost $125 million to $165 million a year in lost revenue. This was little more than the estimated $100 million in lost revenue anticipated as a result of the R.S.I.P. Submissions from the Investment Dealers Association of Canada and the Canadian Chamber of Commerce also urged dropping the capital gains tax, at least temporarily, in order to increase the supply of investment capital.

After examining the proposals, W.A. MacDonald and G.E. Cronkwright concluded:

> " - The proposals can have only a very limited effect on tax distortions of inflation and personal investment income, and will do so only at a price.
>
> - A more direct program that does not involve complex

interaction with the whole income tax system would better serve the immediate interests of new homeowners and small businessmen.

- The accrual system of taxation of capital gains, even recognition of inflation, is contrary to the need to move in the opposite direction. Capital should be treated as a pool which is only taxed on its capital-gain component if converted to consumption or on death or emigration (if capital gains should be taxed at all in a country that needs more capital investment than it is getting and wants to own more and more of its own industry).

- The fragmentation of capital markets by radically different tax treatment of essentially the same financial instruments is likely to prove counterproductive to economic recovery and efficient allocation of capital."[27]

The Ontario Economic Council also had many criticisms of the federal government's proposals. Although it endorsed the principle of indexation of investment income, the Council said the R.S.I.P. was "too restrictive and would generate substantial new distortions."[28] In a position paper released by its chairman, T. Courchene, concern was expressed about the danger of substantial government intrusion in the operation of financial institutions. "The Council feels that although the federal proposals, as presently constituted, do go some way toward this goal, the costs of the proposals in terms of new distortions, increased uncertainty, and further regulation of the capital markets outweigh the benefits."[29]

It was clear that the business community was at the heart of the push for the R.S.I.P. proposals. The ad hoc committee appointed by the Finance Minister to report on the practicality of the proposals was chaired by Pierre Lortie, the President of the Montreal Stock Exchange. The members of the Committee were

prominent individuals from the financial, accounting and economic communities, a "blue-ribbon committee." Among others, officials of the Department of Finance made representations to the Committee that repealing the tax on capital gains would be unfair and result in increased difficulties in enforcement of the tax system. Yet a significant number of submissions and some Committee members preferred eliminating the tax to any inflation-adjustment scheme as a way to help the ailing capital market.

The Lortie Committee Report identified three solutions to the distortions caused by inflation. These were: 1) greatly reduce or eliminate inflation; 2) change conventional taxation and accounting concepts to reflect current rather than historic costs; and 3) "in the absence of comprehensive changes in the definition of taxable income, modify the tax system where feasible to reduce or eliminate the effects of inflation on the taxation of investment income."[30] The Committee did not support the Indexed Term Deposit and Indexed Term Loan proposals. It concluded that the proposals, in providing short-term economic assistance to certain sectors, were too narrowly focused. The Committee felt that their implementation would cause serious economic distortions. They presented a strong case for the general feeling of economists that long-term structural changes in the tax system should not be made to deal with shorter-run cyclical problems.

They noted two general types of responses to the Government's R.S.I.P. proposal. "The first argued that the proposal's objectives should be achieved in entirely different

ways, either through the elimination or substantial reduction of the capital gains tax, or through the general indexing of the cost base of all assets. The second concentrated on perceived deficiencies in the design of the Paper's proposal, such as the accrual basis of taxation."[31]

The Committee's conclusion was that a modified R.S.I.P. would be feasible. Their basic criticism of the original proposal related to the accrual basis for taxation. They said it was a "dangerous precedent and would pose liquidity problems for many investors."[32] The concern was with those investors who seldom trade and would not realize gains at the rate they accrued. Instead, the Committee recommended that no more than 35 percent of the net balance of gains or losses be considered as income or as a deductible loss in the current year. It was accepted that limited accrual made it easier to calculate tax liability because inflation indexing could be done on a pooled basis. The remaining balance would be included in income in subsequent years on a declining balance basis at 35 percent each year.

The following table illustrates the Lortie Committee's approach to the R.S.I.P.:[33]

**Simplified Example of Calculation of Taxable Gains and Allowable Losses in the Modified RSIP**

| | | | |
|---|---|---|---|
| **First Year** | | | |
| Jan. 1 | Purchase of shares in Co. A | | $200 |
| | Purchase of shares in Co. B | | 300 |
| Dec. 31 | Total cost of investments | | $500 |
| | Add - adjustment to cost base for inflation (assumed to be 10%) | | 50 |
| | | | $550 |
| Dec. 31 | Market value of securities in the RSIP | $700 | |
| | Less - adjusted cost base | 500 | |
| | Gain | $150 | |
| | Portion of gain to be recognized in income - 35% of $150 | 53* | |
| | Gain deferred | $ 97 | |
| | Add to cost base amount of gain recognized | | 53 |
| **Second Year** | | | |
| Jan. 1 | Cost base of investment | | $603 |

* One half of this gain would be included in taxable income.

The Committee also recommended that existing eligible shareholdings be transferable into the Plan. For tax purposes, shares would be deemed disposed of at current market value on the date of transfer into an R.S.I.P. The deemed gains and losses would be treated in the normal manner in that year. This modification was a significant change from the original C.I.P. and the Government's R.S.I.P. because it would lessen the

incentive for new capital investments and this was one of the principle objectives of the original proposals.

G. Pitts of the Financial Post reported public reactions to the Lortie Report. "Investment industry sources feel the formula adds unwieldy complexity to the R.S.I.P. And they're concerned that even a limited accrual would discourage investors from using the R.S.I.P."[34] Norman Heimlich, vice-president and chief economist of F.H. Deacon Hodgson Inc. of Montreal questioned the reasoning behind taxing accrued gains at all if the plans were to increase equity investment. "By taxing unrealized gains even moderately, Ottawa retards the flow of funds that might otherwise be available for investment in equities. In short, 'It impedes the cash flow'."[35] The President of the Investment Funds Institute of Canada, Keith Douglas, thought that many prospective R.S.I.P. customers "could be driven away from the plans because they feel they shouldn't pay tax on unrealized gains."[36]

S. Kelman of the Financial Times of Canada summed up the feelings toward the R.S.I.P.:

> "At present, no one is sure how much will flow into RSIPs, though figures of hundreds of millions or even billions of dollars are bandied about.
>
> "That kind of uncertainty over RSIPs' drawing power has at least one major investment house taking a wait-and-see attitude. The firm's vice-president says he wants to see how large the market will be before jumping on the RSIP bandwagon. He, for one, does not expect it will be a mass-market tax shelter because 'most people have a limited amount of cash flow they can direct into savings' and they are likely to choose RRSPs first."[37]

## The Indexed Security Investment Plan

Further consultation with the investment community honed the R.S.I.P. to where only 25 percent of annual accrued capital gains (or losses) would be brought into income for tax purposes. By October 1983, it seemed that "after a somewhat less than heart-warming birth, that child of joint consultations between Finance and the Investment Dealers Association, the R.S.I.P. is beginning to look as if there is life in it."[38] What may have been more significant was the"general feeling that the business community is getting a place by the fire again" was "noted by the markets."[39] Observers were not only watching the actual reforms but also the political processes leading to reforms.

The CIP/RSIP went into effect under a new name - ISIP (Indexed Security Investment Plan) -- on October 3, 1983. The legislation followed the recommendations of private sector representatives closely. Key features of the new plan were outlined in Canadian Tax News:[40]

- The ISIP will be made available to individuals residing in Canada and to Canadian trusts. Eligible administrators of ISIP's are investment dealers, brokers, banks, credit unions, trust companies,mutual fund corporations, mutual fund trusts and insurers. Qualified securities that can be purchased through an ISIP are common shares of corporations that are incorporated in Canada, have their head office in Canada and are listed on a Canadian Stock Exchange, and certain warrants, rights and options which are publicly traded in Canada for the purchase of these shares. In addition, units and shares of mutual funds and interests in segregated funds of an insurance company will also qualify as eligible investments if the mutual fund or insurance company also administers that ISIP. However, the benefit under the ISIP proposal will not be available if the investment in non-qualified investments exceeds 40% of total assets, and will be reduced proportionately to the amount that the mutual fund or

insurance company invests in non-qualifying securities in excess of 10% of their portfolio.

- The Finance Minister has set an effective date of October 1, 1983 for the introduction of the ISIP. Eligible participants may transfer existing qualified securities into an ISIP, although the transfer must be made at fair market value with resulting capital gains or losses being recognized in the usual manner.

- All record keeping and calculations for ISIP's will be done by the administrator of the plan. The cost of securities purchased in the plan will be indexed monthly by reference to the Consumer Price Index. At the end of each year, the indexed total will then be compared to the fair market value of the securities in the plan, and the difference is the participant's "real" gain or loss.

- 25% of real gains and losses in the participant's plan will be recognized as capital gains or losses for tax purposes. The remaining 75% will be deferred by adjusting the participant's indexed pool. One-half of the recognized gains will be included as usual in the participant's income for tax purposes. However, the deduction of one-half the capital losses can be made against other income in the year without the usual limit of $2,000.

- Dividends received on securities in an ISIP will continue to receive the gross up and dividend tax credit treatment. Dividends received and capital gains incurred on ISIP securities will not be eligible for the $1,000 investment income deduction. Interest on funds borrowed for ISIP investments will not be deductible, although ISIP investments will be eligible as collateral for other loans.

- There is no limit on the amount that can be invested in an ISIP nor is there any limit to the number of ISIP's an investor can have.

- The draft income tax legislation for the ISIP proposal is quite complex, and requires further analysis.

The ISIP, which is a written contract between an investor and the administrator of the plan, would work as follows:[41]

| Date | Transaction | Inflation Adjustment (1% a Month) | | Cost Base |
|---|---|---|---|---|
| Year 1 | | | | |
| Jan. 1 | Purchase of 100 shares of Security A | | | $2,000 |
| June 30 | Inflation adjustment | $120 | | |
| July 1 | Sale of 50 shares of Security A | | | 1,700<br>300 |
| Dec. 31 | Inflation adjustment | 18 | | 138 |
| Dec. 31 | Indexed cost base | | | 438 |
| | Closing market value of ISIP | | $1,600 | |
| | Indexed cost base | | 438 | |
| | Gain | | 1,162 | |
| | Deferred gain - 75% | | (872) | |
| | Recognized gain - 25% | | $ 290 | |
| | Taxable capital gain (1/2 of recognized gain) | | $ 145 | |
| Year 2 | | | | |
| Jan. 1 | Opening market value of ISIP | | | $1,600 |
| | Deferred gain | | | (872) |
| | Opening cost base | | | $ 728 |

The investor in this ISIP recognizes a "real" capital gain of $290, and must include half of this amount, $145, in income. The balance of the real capital gain, $872, is netted against the real gains and losses of the following year, and 25% of the net result is recognized in that year.

If the investor had conducted the transactions outside an ISIP, he would have made a capital gain of $700 and would have included $350 in income. This is $205 more than under the ISIP.

> The net advantage or disadvantage of ISIP will depend on the annual rate of inflation, the annual growth rate of the investment portfolio, the expected holding period of the portfolio and a number of other variables.

John Bossons wrote that the ISIP would be particularly attractive to those who traded frequently (deferral of tax on 75 percent of annual capital gains) and high-risk investors because of the generous loss-offset provisions. (There would be no annual limit on the allowable capital losses deductible from their income.) "Once the plan's benefits become generally understood, it would draw additional funds into the stock market and, as a result, have a strong positive effect on stock prices,"[42] was Bossons' feeling. At the investment firm of McLeod Young Weir Ltd., it was estimated that eventually 50 percent of their retail clients would do most of their share trading in an ISIP. "I feel there could be a heavy demand in the future,"[43] said director, Sandy Miller. Clearly, the overall attitude towards ISIPs had begun to change.

Despite the optimistic words of financial analysts, it seems that "in most parts of the country there's little expectation of a big rush into ISIPs."[44] In his remarks on ISIPs at the Annual Conference of the Canadian Tax Foundation in 1983, George Weinberger concluded: "For the investor with a small portfolio of Canadian stocks, the return in absolute dollars will probably be very low. While it is true that most taxpayers will look for opportunities to earn an extra percent or two even on a small investment, there may be a question in the minds of

investors with small portfolios whether the added complexity and added attention required by the ISIP will warrant the additional tax savings."[45]

ISIPs are still very new, yet few investors seem to be willing to undergo the increased administrative burden to convert their portfolios. Everyone is extremely hesitant to involve themselves until the smoke has cleared. This does not bode well for the original objective of increasing investment in Canada's capital markets.

Hopefully, the ISIP is not the last stage in the government's attempts to reduce the distorting effects of inflation on the taxation of capital gains. If it is, we have got ourselves an extremely narrow solution for an extremely broad-based problem. In particular, small investors will find it of no value whatsoever since ISIP gains are not eligible for the $1,000 investment income deduction. Large investors may not think it is worth the administrative complexity. At the moment, it seems highly unlikely that the ISIP will result in a significant increase of investments in the capital market. The ISIP may be another piecemeal attempt to solve a problem that can only be solved by fundamental reforms.

## END NOTES

1. John Bossons, "Inflation, Indexing and The Tax System", Thirty-Fourth Tax Conference Proceedings, 1982, (Toronto: Canadian Tax Foundation, 1983) p.482.

2. Ibid., p.481.

3. Ibid., p.482.

4. John Helliwell, "Inflation and Tax Reform", Canadian Tax Journal, XXVII, 2, (March-April, 1970) p.129.

5. Robert M. Clark, "Inflation, Taxation and The White Paper", Annual Tax Conference, 1970, (Toronto: Canadian Tax Foundation, 1971) p.223.

6. Ibid., p.227.

7. From John Bossons and Thomas A. Wilson, "Adjusting Tax Rates for Inflation", Canadian Tax Journal, XXI, 3 (May-June 1973) p.198.

8. House of Commons Debates, January 29, 1975, 2710.

9. Meyer Bucovetsky, "Inflation and the Personal Tax Base: The Capital Gains Issue", Canadian Tax Journal, XXV, 1, (January-February 1977) p.81.

10. Ibid., p.80.

11. Ibid., pp.83-84.

12. Ibid., p.100.

13. Bossons and Wilson, p.199.

14. Speech to the Conference Board in Canada, 1973, by Henry H. Fowler, former U.S. Treasury Secretary.

15. Submission to the Department of Finance by the Four Stock Exchanges and the Investment Dealers Association, September 1974, p.3.

    This calculation is based on the Indicator Digest Average consisting of 1500 New York Stock Exchange listings on an unweighted basis. The more narrowly based Dow Jones Industrial Index has fallen some 40 percent in the period while the Toronto Stock Exchange Industrial Index has fallen 33 percent from its historic high in 1973.

16. Ibid., p.6

    This statement is from a speech by the Honourable Alastair Gillespie, June 5, 1973.

17. Ibid., Appendix A.

18. Ibid., p.8

19. To the Honourable A.J. MacEachen, "Inflation and the Taxation of Personal Investment Income", Paper for Consultation, (Ottawa: Department of Finance, June 1982) p.7.

20. Ibid., p.6.

21. Ibid., p.7.

22. N. Bruce, "Indexation Plan Doesn't Go Far Enough", Financial Post, 14 August 1982.

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## 11. TRANSFORMATION OF THE FEDERAL MANUFACTURERS' SALES TAX INTO A SALES TAX LEVIED AT THE WHOLESALE LEVEL

### Historical Overview

In Canada, two major forms of sales taxes are the retail sales taxes which are imposed by all the provinces except Alberta and the manufacturers' sales tax, imposed by the federal government. In a report on the provincial sales taxes, John Due wrote:

> "The basic weakness of the over-all Canadian tax structure is the multiplication of sales taxes through their use by both Federal and provincial governments. The combined burden of Federal sales and excise taxes and provincial sales taxes would appear to place a disproportionate amount of the total tax burden in the country on the basis of expenditure rather than upon income, and thus to penalize too greatly the persons who are compelled to spend high percentages of their incomes ... The basic fault lies not with the provinces,which have no other place in which to turn, but with the heavy reliance placed by the Federal government upon sales and excise taxation when it could obtain this revenue from other revenue from other sources."[1]

Whereas the federal government has unlimited taxing powers, s.92(2) of the Constitution Act, 1867 restricts the provinces to "direct taxation within the Province in order to the raising of revenue for Provincial purposes."[2] However, the provinces actually do have other places to turn. They may, and do charge differing rates for personal income tax on their residents, although the federal government collects this tax. The provinces would prefer though, that the sales tax field be left entirely to them.

In order to pay the costs of World War I, sales taxation in Canada was first introduced by the federal government in 1920. The provinces began levying sales taxes in the 1930's and their powers in this area were confirmed by the Privy Council in the "Atlantic Smoke Shops"[3] case in 1940. In this case it was held that the sales tax was a direct tax, since it was levied upon the final purchaser, who could not shift it to anyone. The first federal levy was in the form of a 1 percent 'turnover tax', meaning that the tax applied to the sale of a good every time it passed from one firm to another. However, this form was highly disadvantageous to non-integrated firms, whose protests convinced the government to implement a 6 percent manufacturers' tax in its place in 1924. The rate was reduced to 1 percent in 1930 and the tax was to be eliminated the next year because of public opposition to it. Instead, the rate was increased to 4 percent in 1931 and 8 percent in 1936. The government needed new revenue sources because of the deficit caused by the Great Depression and public opinion had to go by the wayside. This characterized the way the manufacturers' sales tax would be used from then on. The need for revenue increased with the start of World War II and this event marked the acceptance of the tax as "a permanent part of the Canadian tax system."[4] The rate of the tax rose again to 11 percent, only after the outbreak of the Korean War in 1950, when again the government needed to finance extra military spending. Between 1967 and 1978, the tax rate had reached its maximum of 12 percent and since 1978, it has remained at 9 percent.

**The MST - Structure**

The Excise Tax Act charges that "There shall be imposed, levied and collected a consumption or sales tax of 9 percent on the sale price of all goods; a) produced or manufactured in Canada; b) imported into Canada ... payable by the producer or manufacturer at the time when the goods are delivered or at the time when property passes, whichever is the earlier."[5] The MST is based on the price charged before tax and the tax base includes the buyer's liability for advertising, warranty and commission costs. However, for imported goods the tax base is the 'duty paid value' (value for duty, plus duty) and so, it excludes these marketing costs which are added by importers. Exemptions from this tax have been allowed for some producers' goods to avoid double taxation of materials incorporated into manufactured goods. These exemptions depend upon the end-use of the product or upon the status of the purchaser. This means that when a manufacturer imports or buys raw materials or partly manufactured goods for further manufacture or for incorporation into his finished product; or when he buys equipment for production, the goods will be exempt from tax. In addition, consumer goods such as foods, drugs and clothing, have been unconditionally exempted to reduce the perceived regressivity of the tax.

The Canadian government can use the MST as a tool to achieve policy goals by imposing it on certain sectors of the economy and so influence marketing and manufacturing patterns.

The MST is also the "third largest"[6] revenue source and a permanent part of the Canadian tax structure. "Governments have typically regarded it as an evil necessity to raise adequate revenue without further resort to other taxes."[7]

For the general public, the key to this tax is the fact that only the manufacturer or licensed wholesaler is concerned with calculating it. "Once the goods pass through his door, the tax becomes an invisible component of practically everything we purchase other than what is specifically exempted."[8] The ultimate taxpayer, the consumer, cannot relate the benefits received from government expenditure to tax costs because the tax is hidden. Yet the MST inevitably forces the community as a whole to consume fewer privately produced goods, and instead receive more governmentally-produced services. Recently, the Financial Post noted that our rising standard of affluence has obscured the impact of taxation "and desensitized us. Most disturbing, taxes reduce our choices of how to live and what to buy because government makes those choices for us."[9]

**Problems**

In The Wealth of Nations, Adam Smith wrote that "A good tax should be equally spread among the subjects of state, certain to be imposed and not arbitrary, levied in a way that is convenient for the taxpayer and cheap to collect."[10] It was clear by 1955 that the MST was none of these things. The Finance Minister announced in the April Budget speech that: "the Minister of National Revenue and I are concerned about the present statutory

provisions with regard to the base on which the tax rate applies. The problem arises when manufacturers sell to customers at different levels in the marketing process."[11]

Actually, seven disadvantages of the MST have been identified. The problems with this form of taxation are: pyramiding, neutrality, invisibility, determining the taxable price, the treatment of private brand goods, the inclusion of transportation costs in the tax base and the valuation of imports. Pyramiding is "the process by which the final price to the consumer rises by more than the yield of the tax."[12] It is felt that since the MST does not result in uniform proportionate increases in final selling prices of taxed commodities, the tax distorts the structure of relative prices. This is evident with any tax applied in early stages of production. Critics of the tax claim that it interferes with decisions about the use of economic resources and therefore, it is not neutral.

The third problem, the fact that the MST is invisible to those who finally pay it "is an invitation to increased Federal spending (and) to increased, rather than lighter taxes."[13] When the U.S. government was studying proposals to implement a MST, it was reported that "the MST would probably be shifted very substantially to the consumers ... (and) would tax consumer purchasing."[14] At the same time, it is argued that "there can be little doubt that most people in Canada are unaware of the existence of the MST."[15] Clearly, the hidden nature of the tax marks it as uncertain and unsafe.

The fourth problem, determining the taxable price of goods, comes from the variations in the extent of distribution activities, costs and margins among various manufacturers and distributors. If manufacturers sell directly to the public or retailers, their price is higher than the selling price of those selling to wholesalers. The current practice of the Department of National Revenue allows manufacturers who perform some wholesaler functions a percentage deduction from the selling price-tax base "to eliminate the value of the wholesale services."[16] However, the methods of calculating this deduction are necessarily highly arbitrary because of the variations in integration within a given business sector. Thus, the tax bases for competing manufacturers may differ. If there is a perceived unfairness in the sales tax treatment of competitors, one competitor could request another valuation of his goods for tax. Yet he could not find out what his competitor's 'value for tax' is. Distortions result from application of the tax at different points in the production-marketing process in that a higher or lower proportion of final value is added after the application of tax. Moreover, the 'sale price' deemed by the Department cannot be appealed. Because this deeming procedure has no legislative base and is simply an administrative practice, it is not subject to judicial review.

The fifth problem of the MST is the fact that brand name goods are favoured by the system. Goods with a merchandiser's brand name, such as Eaton's "Viking" line, do not have advertising, warranty or risk costs included in the

manufacturer's selling price because the merchandiser assumes these costs. Therefore, these costs escape the tax. On the other hand, when the manufacturer markets his own goods, these costs are included in his tax base. Thus, he has a higher tax base although his goods may be competing with brand name goods.

The method of calculating the tax base is a problem for local manufacturers relying on distant supply sources. They must pay higher taxes than competing manufacturers who are located near to their supply sources. This anomaly occurs because the MST applies to inward transportation costs (freight and costs of moving materials and components to a factory) but not outward transportation costs (costs of moving finished products from a factory to a wholesaler.) This discriminatory tax treatment distorts business decisions regarding location. It encourages businesses to manufacture products outside the country. The country loses not only tax revenues, but employment opportunities for its citizens as well because of this tax policy.

The MST's worst defect, or at least the one causing the greatest disturbance in the business community, is the fact that the tax system treats imported goods more favourably than Canadian manufactured goods. The value-for-duty tax base for imports excludes the advertising, warranty and marketing costs of the goods that are added by importers. This is more encouragement for domestic manufacturers to move operations to foreign countries, to avoid these costs being included in their tax base.

**History of the Reform Process**

In a paper presented at the Canadian Tax Foundation's 1982 Sales Tax Conference, J.A. Johnson noted that the major emphasis of the many government groups to have studied the MST has been "on the economic consistency goal, particularly neutrality, and the ease of administration goal"[17] of tax reform. Thus, since 1940 Committees have searched for ways of making the tax have a less distorting effect on decisions regarding economic resources and of making it "simple to understand, easy to compute (and) convenient to pay."[18]

The Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Commission) in 1940, criticized the MST for its non-neutral impact because it was a regressive burden on lower-income groups, forced to spend larger percentages of their family money income on the tax than higher-income groups. No action was taken by the government in response to these criticisms. It would take a louder protest, from the public itself, before government action could be triggered.

In 1952, Tax Bulletin noted "the lack of knowledge by Management generally of the incidence and effect of the tax and ... the extremely voluminous and complicated series of exemptions and rules issued and revised regularly by the Department of National Revenue."[19] A Canadian Tax Foundation study released in 1955 showed that 24 percent of the revenue from the MST in 1954 was for goods "purchased by industry."[20] From this, it was concluded that the MST was not operating as a single-stage

commodity tax at all, but rather as a multiple-stage tax. The separate collection of sales taxes by the Federal and provincial governments was also felt to result in "wasteful effort and added complications for many business firms."[21]

It seems likely that the growing realization within the business sector of the "widespread over-payment of the Sales Tax,"[22] rather than inequities within the tax system, prompted the Finance Minister to appoint the Carter Sales Tax Committee in 1955. The Committee's terms of reference were: to examine problems where manufacturers sell to customers at different levels in the marketing process; to study the problems of import competition; to study the appeal procedure; and to study the exemptions from the tax.

In 1956, the Committee recommended:

> At some future date after suitable preparation and explanation to taxpayers, the basis of the tax be changed from the manufacturers' level to the level at which retailers purchase goods. This is the level used for sales tax purposes in Australia. It follows that the broader base will produce increased revenue at the same rate. To obtain the same revenue the rates of sales and excise taxes may be reduced equivalent to the average wholesaler's mark-up and this recommendation is made conditional upon such a reduction."[23]

It was recognized by the Committee though, that shifting the tax to the wholesale level would favour large retail merchants over small ones. Since large retailers could eliminate some distribution costs that would be caught in the tax base at the wholesale level, the tax on their purchases would be less.

A shift of the tax to the wholesale level might increase its neutrality because at this closer stage, it would be a more

uniform percentage of consumer expenditures. A wholesale level tax would equalize the tax treatment of domestic and imported goods by including items in the tax base of imports that were included in the domestic tax base. Moreover, this tax could be applied to an actual selling price and the arbitrary system of assigning notional values for sales by passing wholesalers could be abolished. However, the Committee recognized the problem of determining the taxable selling price for large retail merchants with wholesaling and manufacturing functions. Critics argued that because large retailers made up large parts of the market, the notional value system would not be abolished at all. Furthermore, small retail firms would suffer because of the distribution costs included in the tax base of their goods that large retailers could eliminate.

The next phase in the reform process came when the Royal Commission on Taxation invited submissions on the Sales Tax in 1964. Despite the fact that a representative of the Rubber Association of Canada admitted that the sales tax was not "much of a burden "[24] only two briefs supported the existing MST. The Canadian Wholesale Council emphasized that a change to a wholesale basis for the tax would seriously disrupt the entire distribution system and "an increased burden would be placed on government offices and field staff."[25] The Retail Merchants Association of Canada said "the burden of collection should not be placed upon the retailer."[26]

Many more briefs to the Commission argued forcefully against the MST. The Shoe Manufacturers' Association of Canada

stated that high taxes had "a stultifying effect upon the industry."[27] A representative of plastics manufacturers warned that his industry would "become uncompetitive with the U.S."[28] because of the tax. Construction, Lumbermen's Associations and the Motor Vehicle Manufacturers' Association petitioned for the abolition of the sales tax on building materials. The Canadian Manufacturers' Association brief stated that the present MST and the provincial retail sales taxes together were putting a double burden on taxpayers. It recommended one uniform sales tax imposed at the wholesale level.

The most frequent recommendation in the briefs to the Carter Commission was shifting the tax to the retail level. The broader base would allow services to be taxed. The burden of a retail sales tax would be more uniform and it would avoid the pyramiding problem (the tendency to amplify retail prices). The Canadian Business Equipment Manufacturers' Association felt that this system would be simpler to administer because provincial and federal taxes could be collected simultaneously. The Rubber Association of Canada noted that this would equalize the tax treatment of small and large retailers and eliminate the tax advantage "presently enjoyed by imports over domestic goods."[29] La Chambre de Commerce du District de Montreal said the shift would "bring home to the consumer the amount of the tax that he is called upon to pay."[30]

In a study for the Commission, A. Tarasofsky argued convincingly that the only change in the taxpayers' situation that would come about with a shift to the retail level would be a

change in awareness of the tax and "nowhere...has the taxpayer rebelled simply because he became fully conscious of the fact that he was bearing a certain tax load."[32] He felt that doubts about the viability of a federal retail sales tax were not realistic. The only concern was that of politicians who preferred a less visible form of taxation, hoping that the taxpayer/voter was less "antagonistic to those taxes that intrude least starkly on his consciousness."[32]

From its investigation, the Carter Commission concluded that the MST should indeed be replaced with a retail level sales tax. The government "should adopt a sales tax base that removed the regressiveness of the tax by exempting food, shelter and producer goods; it should try to negotiate arrangements under which the provinces adopted the same sales tax base and acted as sales tax collection agents for the federal government; and it should try to negotiate an exchange of more sales tax room for the provinces for more direct tax room for the federal government."[33] Thus, the eventual aim would be to transfer the sales tax to the provinces entirely.

Yet the insurmountable political problems posed by the Carter Recommendation were well-recognized. Firstly, the fact that the MST is a hidden tax would mean that shifting it to the retail level would be perceived to be an increase in taxes. "It would not be surprising if most people viewed the new rate as a new tax."[34] This public perception would not be weakened even if there was no change in federal revenue. However, the most difficult issue to face would be the opposition of the provincial

governments. At a time when the provinces were desperately searching for more revenue, the imposition of a tax at the retail level by the federal government would seem to "pre-empt this field."[35]

Richard Bird wrote:

> "... the principal reason for doubting the implementation of the retail sales tax proposal is that the provinces will not be willing to accept it. Why should they, when the Commission, like everyone else, tells them it is an inherently bad tax? When, furthermore, they are told sales tax revenues are less responsive to increases in income than are income taxes? And when they would bear the political onus for imposing the highest explicit general retail sales tax rates ever levied in the world? No matter how mature Canadian democracy is, it is unlikely to swallow such a dramatic apparent (if not real) change without considerable reaction, and it would be the provincial governments which would feel the pressure. Furthermore, given the present state of political feeling in Canada,would many provinces be willing to accept the further degree of federal control over their revenues implied by the Commission proposal? It is all very well to say they have rate flexibility, but as everyone concerned with taxes knows, base flexibility can be an even more useful political tool - even where its economic effects are not all they should be - and thus the provinces would lose under the full-fledged Commission proposal."[36]

He concluded that the proposal would fail only because of political reasons and an economic cost would be paid for the failure. Because of the high visibility of a retail sales tax it was too dangerous politically.

**Post-Carter Reforms**

The 1969 White Paper on Tax Reform, the government's response to the Carter Report, stated that reform of the Federal sales tax would begin after the restructuring of the income tax system. In 1975, when major portions of the Income Tax Act had

been revised, a Discussion Paper (the Green Paper) on Federal Sales and Excise Taxation was released by Finance Minister John Turner. The Green Paper indicated the three basic alternatives to the existing MST: restructuring the tax at the same level, moving the tax to the wholesale level, or moving the tax to the retail level. The stated preference was for a shift to the wholesale level, although public representations on alternative proposals were invited.

The Green Paper outlined the benefits of a wholesale level tax:

> "Introduction of a wholesale sales tax would substantially resolve the competitive distortions that exist under the manufacturers' sales tax and would remove the potential tax advantages that may accrue to imported goods. Application of the tax on the sale price of goods to retailers would provide a uniform valuation basis, as this is a trade level at which virtually all goods converge, and the tax would closely approximate a constant percentage of the sale price to consumers for all taxable goods. Furthermore, such a move would facilitate taxpayer compliance and minimize transitional difficulties since taxpayers at the wholesale level would largely be comprised of the same taxpayers currently required to pay the manufacturer's sales tax."[37]

Yet of the two hundred submissions received, only "10 percent"[38] responded favourably to the wholesale level proposal. Surprisingly, 33 percent of the responses favoured retaining the MST. The Financial Post reported that at this point the Retail Council of Canada "intensified its opposition"[39] to changes in the sales tax system. On the other hand, the Canadian Institute of Chartered Accountants' Sales Tax Task Force supported a shift to the retail level. The group argued, "Is concern over public acceptance a valid reason for keeping any tax hidden?"[40]

The Commodity Tax Review Group, made up of members from the Department of Finance and the Department of National Revenue, was established to analyze these submissions. Their Brown Paper Report was made public in 1977. This group concluded that the best solution was to move the tax to the wholesale level, despite the fact that it found that a retail sales tax would be the most neutral level for commodity taxation. One wonders then, about Finance Minister John Turner's claim that the Green Paper was to "encourage public participation"[41] in the tax reform process. Obviously, participation by the public did not influence the decision of the Commodity Tax Review Group.

The media clearly felt that the purported public participation in the process had been a farce. The Commodity Tax Review Group reported that a retail level sales tax gave the government less power over the economy since it "would no longer be able to stimulate sectors of the economy by reducing the sales tax on certain products."[42] However, the Globe and Mail charged that the unlikelihood of obtaining provincial co-operation was "at the heart of the rejection."[43] The Group Chairman was reported to have been encouraged by the fact that no public reaction had been apparent "other than from some persons who would continue to reiterate the same objection that they voiced in their first submissions."[44] The Financial Times reported that "the Group seemed to reject the feelings and suggestions made in the submitted briefs,"[45] anyway.

Reactions to the Group's Brown Paper Report were extremely negative. "No one in the business community, it seems, fully

supports the government's proposed plan."[46] The Consumers' Association of Canada argued that a retail sales tax was most equitable. The Canadian Federation of Independent Businesses, representing 45,000 owner-managers of small companies, called it a "snow job"[47] by the government by which it would increase revenues without appearing to raise taxes. The wholesale level tax would increase the burden on small business because large retailers could integrate many wholesale functions and avoid the tax. The Canadian Importers Association, knowing that imports would be more costly under the proposed system, saw the changes as wiping out many importers.

In 1978, the government sent the Brown Paper proposals to the House Committee on Finance, Trade and Economic Affairs for more study and discussion. This Committee again asked for public input "but never got around to examining it."[48] In the mean time, the MST was cut from 12 percent to 9 percent to stimulate growth in the economy and appliance sales showed a rise of 5 percent. The Canadian Appliance Manufacturers Association attributed the increase in sales to the tax cut. The Financial Post said the tax cut had the "immense merit of easing prices as well as creating jobs."[49]

Whatever discussion took place in front of the Committee the Brown Paper, little of it was reported to the public. Yet the November 1981 Budget announced the change to a wholesale tax. Finance Minister MacEachen said that it would remove the disadvantages felt by domestic manufacturers competing with imports where the existing MST was higher than the tax on similar

imported goods. The inequity between wholesalers and retail changes would be offset, he said, by an additional tax on non-food items to be paid by retailers buying directly from manufacturers.

In April 1982, the White Paper "Proposal to Shift the Federal Sales Tax to the Wholesale Trade Level" was issued with a request from the Finance Minister for submissions from interested parties. Now, the wholesalers were ready to fight. They felt that the tax advantage imports received, "the major economic wrong the tax shift is supposed to right,"[50] would have been better addressed by trade legislation. Wholesalers did not want the costly administrative problems or the "two to three percent consumer price increase."[51]

This time business leaders joined forces to attack the proposals. In October, representatives of 32 business associations "that they said account(ed) for at least 75 percent of employment in the private sector,"[53] met with Finance Minister LaLonde on the issue. The Retail Council of Canada said the tax "could create as many anomalies in tax collections as it would solve."[54] The Canadian Tire Corporation was particularly concerned; it wholesales to its retail outlets an estimated one million dollars as the cost of adjustments and $100,000 yearly compliance costs under the new system. A tax partner at the accounting firm of Touche, Ross felt that the change would be "highly inflationary"[55] and cost businessmen millions of dollars.

The group most eager to see the proposed changes implemented, "the biggest single winners on the wholesale sales

tax issue,"[56] was the domestic car makers. G.M. of Canada Ltd. reported that foreign car makers, notably the Japanese, received an unfair advantage of "between $100 and $200 a car."[57] This was the only group to fight for the change. A G.M. spokesman said: "It's strange and I'm baffled because the other groups which could benefit from it are not coming forward to support it."[58] A paper delivered at tne 1972 Sales Tax Conference of the Canadian Tax Foundation though, pointed out that the different market structures in Canada made it hard to determine exactly who the winners or losers would be. A C.M.A. representative said: "The man in the street won't understand what's going on. Some products may be cheaper, certain ones may cost more, and he won't know why."[59] Retailers were skeptical of whether manufacturers would pass on their tax savings.

In 1983, yet another Committee was formed to study the tax. The Federal Sales Tax Review Committee, chaired by Wolfe Goodman, was made up of seventeen private sector experts in the area. After hearing "numerous horror stories"[60] about a shift to the wholesale level, the Committee recommended shelving the proposal and instead, patching up the current structure of the tax. The report stated:

> "it is the opinion of the Committee that the marginal improvements which shifting the tax to the wholesale level would produce do not justify the disruption which it would cause in an already functioning system."[61]

Although the Goodman group felt that the ultimate goal should be some form of consumer tax, either a retail tax or a valued-added tax, they realized that "the sensitive issue of

federal-provincial jurisdiction"[62] made this reform extremely difficult to implement. The recommendation to keep the MST was "welcomed"[63] by groups like the Canadian Construction Association, which would have become retailers under the proposed statutory definitions. It was understood that the Goodman Report gave the "kiss of death"[64] to the wholesale tax reform.

A year later, Wolfe Goodman said to reporters:

> "It can hardly be doubted that the government's principal motive in appointing the Committee a year ago was to find a way of gracefully backing out of the wholesale tax proposal, which had always appealed more to Finance Officials than to the business community ... only a tax imposed at the consumer level can provide a reasonable degree of uniformity in the tax burden imposed on different kinds of purchases, whereas the present manufacturers' tax or a wholesale tax results in entirely different tax burdens on different purchases ... Perhaps it is too much to hope that rationality will ultimately prevail in this area."[65]

**Conclusion**

The general feeling seems to be that only a retail level sales tax would be the answer to the problems surrounding the present MST. Yet this shift in the tax level seems impossible to accomplish only because of the political backlash. A shift to the wholesale level would cause less of a disturbance politically but a transition to a wholesale tax system would cause many inequities and the end-result would not be that much of an improvement over the present system.

On the surface, the players opposing changes in the MST are the retailers, wholesalers and importers. But these players did not seem to play a role in the government's decision-making

process despite the frequent encouragement of increased public participation in the reforms. The block to real improvements in the system did not come from the private sector, but from the provincial governments. In order to implement a retail-level sales tax, a large amount of co-operation by the provincial governments would have been needed. This co-operation was not forthcoming. The provinces feel that this is their revenue field and resent federal intrusion. Moreover, the high visibility of a consumer tax would make it highly unpopular and provincial governments, as the tax collectors, would probably bear the political costs of the new system.

Faced with the opposition of the provinces to the only real method of improving the federal sales tax (that which had been outlined in the Carter Recommendations in 1966), the many Committees could none of them realistically hope to introduce a tax reform that would be worthy of the costs of implementation. Perhaps then, the entire exercise (the Green Paper, the Brown Paper, the White Paper, and so on) following the Carter Report was futile. The public participation that all the study groups had requested had clearly been of little use. The Federal Government could not listen to the public when its ears were turned towards the provinces.

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## 12. CONCLUDING COMMENTS AND A FEW GENERALIZATIONS

Although the six foregoing Case Studies are based on a reasonably thorough investigation of published materials, the public record does not reveal much of the story. Policies almost invariably reflect a compromise negotiated in private. This is particularly true under a parliamentary system where the executive of majority governments reaches decisions behind closed doors that are veiled in secrecy. Outward pressures may be dwarfed by inward pressures. In this Section some speculation is offered that may cast some light on the kinds of considerations that are usually relevant even if they may not accurately reflect what actually transpired in these instances.

At the outset of this paper a public choice framework was sketched and a derivative non-rigorous framework of analysis set forth. The key concepts were marginal political costs and benefits. In this Section an impressionistic interpretation of each of the Case Studies is offered from this perspective. It is fully acknowledged that these impressionistic interpretations seem rather weak relative to the weight of the analytic apparatus from which they are loosely derived. In part this may reflect the fact that the apparatus itself has not yet been developed to the point where specific, testable (refutable) hypotheses have been formulated. In addition, even the intuitive kinds of hypotheses that emerge from the theory almost certainly require more investigation even if they are to be non-rigorously tested. For example, although the public record gave no prominence to

pressure from tenants' associations in the heated controversy over the Ontario Government's proposals for current value assessments for real property taxes, did they even consider the issue? Interviews with association executives might be revealing. The same might be said of media content analysis. But at this depth a brief case study would be transformed into a full-scale study far beyond the scope of this paper. In short, what follows is lacking both in analytic rigour and informational detail.

A slightly different set of limitations must be borne firmly in mind. Each of the Case Studies largely, although not entirely, abstracts from the particular economic/political climate of the day. Perceptions of the prevailing and anticipated degree of economic prosperity, the timing of elections, the size of the governing party's majority (if any), the ongoing fight for political party control, to name only the obvious, are all relevant considerations. Sometimes the "environmental" factors seem to have been decisive considerations. The immediately preceding and concomitant events in other policy fields are also highly relevant, although they have been ignored here. To go back to the same market assessment valuation question: What role, if any, did the seemingly reluctant introduction by the Davis government of residential rent controls in late September, 1975 have in the decision to later back-off from property tax reform proposed in 1976? The landlords' seeming lack of enthusiasm for the latter may well have been related to the landlords' strenuous but ineffective opposition to the former.

These limitations, in addition to the limitations of a theoretical and empiric nature, should be borne in mind in considering the commentaries on the six Case Studies that follow.

## Case Study Number One: The Abolition of Death Taxes and the Introduction of Taxation of Capital Gains

It would be a serious error to consider the demise of death taxes in Canada in isolation. There is no doubt that the Federal authorities relinquished their occupancy of the Estate Tax primarily as a *quid pro quo* for the acceptance of the deemed realization at death of capital gains (to be taxed at half rates). This change was expected, on balance, to raise additional revenues. The liquidity problems created by taxing both deemed realizations *and* estates (or bequests in the hands of beneficiaries had Carter had his way) were judged to be unduly onerous. The deemed realization feature of the tax on capital gains arose, it will be recalled, because of the difficulties involved in trying to tax capital gains on an accrual basis because of serious evaluation problems for many assets and (the probably lesser) liquidity problems.

In addition to these extreme liquidity problems, several other factors probably contributed to the federal decision to jettison the estate tax: after the deduction of the provincial abatements net federal revenues were extremely small relative to the administration costs as previously noted; most knowledgeable and affluent taxpayers could avoid the tax through long

postponement by means of trusts and other estate "planning" devices; some provincial governments demanded sole occupancy of the field; by rejecting the family as the basic unit for income taxation the Carter "solution" of taxing bequests or income to a recipient outside the family was no longer possible; there was virtually no public support for the social purpose of the estate tax. Those who were concerned about the accumulation of dynastic wealth were mute.

The earlier debate, such as it was,concerning the abolition of death taxes centered almost exclusively on the allegedly adverse economic effects of the tax on saving and investment: Personal saving would be deterred and innovation generating pockets of wealth, particularly as embodied in closely-held family businesses, discouraged. These consequences were asserted rather than argued with supporting evidence and assumed to be adverse without the need for explanation. There was no acknowledgement that in a small open economy changes in domestic saving primarily affect the degree of dependence on foreign saving rather than the rate of interest.

The main social purpose of death taxes, the prevention of massive dynastic wealth, was cited by the Federal Government when it first introduced the estate tax, by the Carter Commission and by the Smith (Ontario) Commission. Apparently this argument had little if any public support. One suspects that the social goal was given much greater weight by officials than by ministers (or commissioners!).

The organized opposition to death taxes came primarily from industry associations, such as those in construction and farming, characterized by many small, closely-held corporate members. These associations existed for other purposes so that the additional organizational costs were zero.

While some of the provinces wanted exclusive occupancy of the death tax field, the low revenue yield, interprovincial competitions plus the opposition of organized interests at the provincial level resulted in the abandonment of the field (except by Quebec) soon after the federal withdrawal.

Whether or not the demise of death taxes in Canada was an improvement or a backward step obviously depends upon the weight one assigns to the competing social and economic objectives and the presumed effects of death taxes on those objectives. Little by way of empirical evidence has been advanced. Superficially it would appear that the austensible economic considerations were given the greatest weight. It is also true, however, that these were the considerations advanced to rationalize the position of the organized opponents that might well have prevailed even in the face of contrary empirical evidence.

Tax reformers would do well to bear in mind the enormous political significance of such symbols as the family farm and the family business. Likewise they should be constantly aware of the vulnerability of the provinces to interest pressures and the interprovincial competition to provide tax havens. The lack of mass media attention can be attributed to the technical nature of the subject matter and its seeming irrelevance, as judged by a

mass audience. Had there been a voice raising the populist cry against the accumulation of dynastic wealth the media coverage perhaps would have been different. Such a figure (or political party) did not emerge.

## Case Study Number Two: Adjustment of Real Property Taxes To Reflect Current Market Valuation in Ontario

Coupling tax structure reform with ill-disguised attempts to increase revenues certainly jeopardizes the success of the former, as frustrated tax reformers are wont to point out when their favourite schemes are either rejected or diluted beyond recognition. This was not the reason why the Government of Ontario failed utterly in its repeated attempts to have market value assessments used as the base for real property taxation throughout the Province. The primary purpose seemingly was to secure to a greater degree the realization of the oft proclaimed horizontal equity objective of "equal treatment of equals". There is little doubt that, from one prespective, the existing real property tax system was and still is grossly unfair. Widely differing tax burdens are borne by the owners of real properties with the same market value. Properties with the same market value bear markedly different tax burdens in different local jurisdictions, or when they are put to different uses or when they are of different vintages. The fact that many provincial grants to municipalities are based, at least in part, on aggregate real property assessments, compounds the unfairness.

Although there are differences in the degree of discrimination within municipalities as well as between them, generally speaking apartment and commercial properties have been over assessed and single-family residences, farms and vacant land have been under assessed. Older buildings have had an advantage relative to newer buildings. Under all of the proposals province-wide consistency would have been achieved and the favourable treatment of older buildings abolished. As described earlier, the unfavourable discriminations against commercial properties would have been reversed by the Smith Committee's proposals, largely eliminated by the Blair Commissions proposals and largely retained by the 1976 Budget proposals. Under all of the proposals residential apartment buildings would have had a tax break (which probably would not have been reflected in lower rents in the short and perhaps medium term). There was also a common recognition in the reform proposals that farmers would not be required to pay significant property taxes whatever the evaluation method.

The Davis Government's decision to back away from current market valuations on a province-wide basis is attributable to several factors: the much heralded success of the California tax rebate (through Proposition 13) that dramatically reduced real property taxes - taxes which had been based on market value assessment; the strong opposition of local government politicians who feared that the anger of the losers would be directed towards them rather than the true "culprit" - the Provincial Government; the adverse effects on sacred cows (e.g. golf courses) and the

favourable effects on public enemies (e.g. distilleries) were used by opponents to their advantage; the lack of public support from the potential winners (e.g. apartment owners and possibly their tenants) under the reform proposals; the reawakening of old hostilities towards any real property tax as a source of revenues for expenditures unrelated to real property; the precarious position of the minority Davis administration.

The principal objective of market value assessment, greater horizontal equity, seems to have had little if any public support. The idea seems to have been much more appealing to officials, elected or appointed, than to voters generally. This may simply reflect, however, that most voters are unorganized and hence inarticulate. The failure to address the enormous difficulties, in equity, of correcting a fault in an old tax that has been capitalized in asset prices may have been a serious oversight. It is not obvious that had the MVA proposals been adopted the transitional inequities would have been less than the long run gains in equity. In the same vein, using any property tax revenues to finance a large part of educational costs, for example, has a weak basis in equity but a strong basis in expediency. It is difficult to engender popular support for a more equitable but still essentially unprincipled expedient. The reform of the real property tax would perhaps have succeeded, one might speculate, had it simultaneously been announced that henceforth education expenditures would be financed through a local income tax surcharge that better reflected ability to pay.

Superficially, one would hardly have expected teachers' organizations and most municipal politicians to be so strongly opposed to the MVA proposals. Without a grandfather clause the fear of shifts in local school board revenues was enough to generate the opposition of the teachers; the fear that local voters would blame local politicians for a tax change not of their making was enough to generate the strong opposition of local politicians. Apartment dwellers, who through competition might have made some longer term gains through lower rents, directed their lobbying efforts towards tightening rent controls. Farmers and developers, both well organized, were effective.

In retrospect, the surprising aspect of the Ontario Government's attempt to reform the real property tax was that it was tried at all. Where were the potential political benefits?

## Case Study Number Three: The Integration of Personal and Corporate Income Taxes

Controversy swirls endlessly around the questions raised by the taxation of corporate source income. Aside from the transparently self-serving purposes of some would-be "reformers", the marked differences among the multitude of competing suggestions probably arise because of crucial differences concerning some basic assumptions. These fundamental differences encompass, in particular, differences in the estimates of the timing and magnitudes, if not the direction, of the direct and indirect effects of the tax changes under alternative internal

and external circumstances. A separate non-integrated corporate tax is anathema to those who believe that corporate taxes are not shifted; to those who believe that investment is highly sensitive to changes in the cost of finance which is determined to a large extent by the after tax rate of return to domestic shareholders; and to those who believe that corporations possess no significant political power, potential or actual, which should be curbed by reducing the cash available for investment finance through retained earnings. The converse also holds. Those who have in mind large, widely held corporate conglomerates see a different picture than those whose image of the typical corporations is that of an aggressive, owner managed potentially expanding business. In point of fact, the shifting issue depends to a high degree on the structure of particular industries; the sensitivity of investment to the cost of finance probably hinges on the relative size of the flow of retained earnings (which in turn depends upon the degree of market power achieved in the past and on earlier dividend policy); the cost of finance is affected by after tax rates of return to the marginal shareholder - resident and non-resident. The relevant considerations are legion.

It is not the purpose here to survey, much less assess, all of the considerations and arguments concerning corporate income taxation in Canada. Suffice it to say that the ground has changed over the years from a concern with double taxation in the 1930s, to the expressed desire to encourage equity ownership by Canadians in the 1950s to the oft-stated importance of tax neutrality in the 1960s to the frantic search for effective

investment incentives in the 1970s and 1980s. Given these changes in emphases it is perhaps surprising that the dividend tax credit introduced in the 1940s should have prevailed largely unchanged except for the "grossing-up" requirements introduced as part of the 1971 tax reform package.

On the basis of hindsight it would appear that, given the small open nature of the Canadian economy, the full integration of Canadian personal and corporate tax for resident shareholders as recommended by the Carter Commission, would have been much less effective in stimulating real capital formation than a refundable investment tax credit of the same revenue cost. The same holds, but to a lesser extent, for the dividend tax credit. It seems unlikely, however, that the significance of this constraint was appreciated in the late 1960s and early 1970s when Carter's full integration proposal was rejected for widely held corporations. What then, were the "real" reasons for the rejection of full integration.

The following reasons seem to have been particularly salient:

1) The favourable discrimination for retained earnings - a major source of saving in Canada - would have been eliminated had they been attributed to shareholders and fully taxed on a current basis at personal rates. The executives of management controlled corporations were much more interested in maintaining high retention rates than in higher share prices. Indeed, they fought the integration proposal.

2) Under Carter, the full integration and the full taxation of capital gains were to go hand in hand. Having decided to tax only one half of capital gains, presumably for political reasons, full integration would have seemed overly generous. Opponents of capital gains taxation thought they might preclude the taxation of capital gains if they squelched integration.

3) Because credit would be given only for corporate taxes actually paid, the effect of full integration would have been to negate all corporate tax concessions. The spokesmen for industries with large, special concessions were therefore strongly opposed.

4) Industries and corporations with significant non-resident shareholders had the same negative reaction.

5) There were enough technical problems with integration, for example with respect to intercorporate dividends, that the opponents could make the scheme appear complex and costly for taxpayer and tax collector.

6) Provincial governments were opposed in large part because they were captured by their industry lobbies.

7) Shareholders generally were not organized.

An important fact of life in Canada is that most of our ideas are imported in finished form. They are not reworked to reflect the unique features of the national condition. As a result, ideas that are appropriate in the United States or Britain, in particular, are absorbed (after a substantial time lag) without adequate modifications. They therefore fail to reflect the extreme openness of the natural resource based Canadian economy, Canada's heavy dependence (up to now) on foreign investment and the extreme sensitivity of investment flows to international differences in taxes, regulations and the like. Imported ideas, like imported wines and films, have a cachet that often proves to be irresistible. They are reflected in the speeches of so-called business leaders in conference themes and eventually in political rhetoric. The point of this observation is not to decry the inevitable but to draw attention to the importance of these external idea "shocks" to the internal policy debate. Obviously it is easier to move with these tides than against them; obviously too, the tides have to be directed around the shoals of particular national circumstances if they are to be utilized effectively in the tax change conflict.

## Case Study Number Four: Introduction of Partial Indexation of the Personal Income Tax

The partial indexation of the federal personal income tax was probably the most significant tax change put into effect in the post 1972 reform period. Because the adoption of the partial indexation scheme substantially reduced federal and provincial tax revenues relative to what they otherwise would have been, it is not surprising that there was no opposition - except from the provincial governments that lost revenues without a corresponding political benefit. The political costs to the federal government were delayed. One relatively modest cost was the increasing demand for the adjustment of business income and capital gains income to reflect inflation - the subject of a separate case study. A more important indirect political cost to the federal and provincial governments arose from the negative effects of partial indexation on government revenues. With reduced revenues, relative to what otherwise would have prevailed, together with expenditures that continued to grow at a rapid rate, in part because of the indexation of some transfer payments, deficits grew and persisted. While the partial indexation of PIT certainly does not explain all of the deficit - weak international economic conditions pre 1983 and high U.S. interest rates were probably more important - it certainly made a significant contribution to it.

The politically painful decision to cap indexation for 1983 and 1984 at 6 and 5 percent, respectively, reflected the importance the federal government attached to the revenue loss.

Gillespie went so far in his Canadian Tax Journal article of November-December, 1983, as to suggest that some of the harsh November 1981 reform proposals were purposefully put forward without expectation of implementation as a means of "softening up" the electorate for revenue raising measures - and in particular the temporary capping of indexation. This explanation seems to ignore the extraordinarily high personal costs such a strategy imposed on the officials responsible for the 1981 budget: Finance Minister Allan MacEachen and Deputy Minister Ian Stewart. Why would they sacrifice their careers in such a Machiavellian scheme?

Nevertheless, it remains valid that partial indexation contributed to the size and persistence of the deficit. For some observers the deficit was taken as a proxy for Liberal Government mismanagement of the economy and/or its own internal administration. Whether the size and persistence of the federal deficit contributed significantly to the defeat of the Liberal Government in the 4 September 1984 election is moot. Presumably it was only one of several negative signals picked up by the electorate.

Another consequence of the growing deficit, particularly in the late 1970s and early 1980s, was the attempted Federal Government expenditure restraint. Although hardly a dramatic success, except in the sense of reducing the rate of growth of expenditures relative to some hypothetical trend, expenditure stringency no doubt made it more difficult to buy political support.

On the other side of the ledger is the fact that without the implicit tax cut of partial indexation the unemployment rate would have been even higher than it was. This would have had negative political consequences too. Perhaps the "right" stabilization measures were taken for all the wrong reasons. The same result could have been obtained, however, by maintaining revenue growth in the absence of indexation and losening up expenditures. Politically this probably would have been the more attractive course of action.

From this perspective, partial indexation was probably a political mistake if one looks at the Liberal administration's record as a whole from 1974 to September 1984. How and why did such a political blunder occur?

As is well known, the discussions between officials and ministers and among ministers and the prime minister are, under the Official Secrets Act, kept in the strictest confidence for a period of some 25 years. The principal actors in the Liberal's decision to adopt partial indexation of the personal income tax in 1974 - a proposal that had been advanced earlier by the Leader of the Opposition Robert Stanfield and rejected out of hand by the Government - therefore cannot, even if they wished to, reveal just who proposed what, to whom and why. Speculation is not unlawful, however. One plausible scenario can be set forth:

a) The 1960s saw a major expansion in the policy reach of the federal government. Many additional programs were introduced. This put a great strain on the decision making

structure and process. The traditional machinery was largely informal with virtually no continuing cabinet committees or documents. The Minister of Finance was preeminent among his colleagues. He controlled absolutely not only macroeconomic policy and taxation policy, but had a veto over all policies deemed to have significant economic effects. Moreover, the Minister of Finance, through his position as President of the Treasury Board, was also responsible for the management of the public service and crown corporations. This centralization of authority in the hands of the Minister of Finance, who necessarily was heavily influenced by officials of the Department of Finance and the Treasury Board Secretariat, was consistent with the fact that the Prime Minister's political clout rested on his ability to form a stable coalition of regional political "barons" (who were made responsible for the key ministries) rather than upon his own popular appeal to the voters.

b) The Liberal's electoral victory of 1968 was almost entirely attributable to Trudeau's "charisma" that guaranteed him the fullest and most fulsome of media coverage. The old regional barons and the Liberal party were largely irrelevant except in nominating candidates who were elected as prime ministerial proxies. Trudeau and his small entourage thus had the opportunity to reshape the decision making machinery to suit both the perceived exigencies of an inherited multi-faceted, interventionist government and his own undoubted

political supremacy. In a series of steps the reach of the authority of the Minister of Finance was reduced. The Treasury Board presidency was assigned to another minister and a secretarial staff placed under his authority. A formal cabinet committee system was instituted including the establishment of a Priorities and Planning Committee chaired by the Prime Minister. This Committee now exercised the veto that previously had been unilaterally held by the Minister of Finance - presumably with the Prime Minister's nominal concurrence. The Privy Council Office controlled cabinet committee agenda, memoranda and records of decision with the extensive strategic advantages that this control entails.

c) The contents of the Fiscal Framework - consisting of the actual and projected revenues, expenditures, net loans and advances and the resulting net cash requirements - had only been made available by the Department of Finance to the ministry and the public as part of the usually annual revenue budget documentation. Although these data were updated each quarter by Finance Department officials, at the time of the release by Statistics Canada of the quarterly National Accounts, they were not disseminated inside the Government. In the late 1960s and early 1970s future revenues were consistently underestimated by Finance with the result that every quarter there was an unanticipated "fiscal dividend" - the result, in large part, of unanticipated (albeit modest) inflation. Because the size of these quarterly fiscal

dividends was not revealed by Finance, the cabinet committees had to accept Finance's determination of the "pot" of unallocated funds from which all new initiatives had to be financed. There was, therefore, a constraint on expenditure growth set unilaterally by Finance.

d) The notion that the Priority and Planning Committee chaired by the Prime Minister could not have access to the most up to date version of the Fiscal Framework was preposterous. However, when senior ministers became cognisant of the windfall revenues increases, through the quarterly circulation to the members of P & P of the previously suppressed revised Fiscal Framework documents, there was a temptation to increase expenditure rather than cut taxes or reduce the debt. The politics of this choice are such that the expenditure increase usually was victorious. Finance, therefore, lost control, to a significant degree, of the expenditure aggregates and did not have the clout to forestall many of the particular spending proposals of the several cabinet committees. It is difficult, to say the least, for a Finance Minister to countermand the decision of a committee of his ostensible peers.

e) In this context, one way to forestall expenditure growth was to cut the growth of inflation induced revenue increases - revenue increases that did not entail increases in nominal rates. One way to reduce this growth in the "fiscal

dividend" was to adopt a system of partial indexation of the personal income tax - a policy decision that was within the unquestioned prerogative of the Minister of Finance. With this one stroke Finance could restore tighter fiscal constraints on the newly established decision making system that had invaded its traditional territory. And it could do so without an annual internal debate about the merits of possible tax cuts.

f) Ministers, for good reason, are ill-informed about the details of the tax structure. By presenting a set of seemingly technical changes concerning indexation, without providing them with information concerning the future revenue growth implications, the approval of colleagues is likely to be automatic.

g) And thus partial indexation came to pass - at least in this hypothetical scenario. A "good" measure passed for less than obvious reasons.

If this hypothetical scenario comes close to reflecting the circumstances that prevailed, one of the determinants of tax reform must be the particular status <u>at the time</u> of the endless struggle for power within a ministry. This struggle is among and between ministers and appointed officials. The battlefield is the "machinery of government". Domination of the decision making process, and hence its outcomes, is the goal.

## Case Study Number Five: Treatment of the Inflationary Component of Capital Gains and Losses

The Indexed Security Investment Plan went into effect on 3 October 1983. It was, as is almost always the case, the result of a painful series of compromises. In this instance the problem was compounded by the earlier (1972) decision to tax only one half of realized rather than accrued capital gains. This "solution", which reflected a multitude of conflicting considerations including the existence of a presumed modest inflationary component, weakened the argument for the indexation of capital gains. It also raised the hope, if not the expectation, that the well recognized problem for investment created by double digit inflation would be met by excluding capital gains from the tax base altogether. To this end, some of the organized interest groups, such as small business organizations, pressed for the exemption of capital gains rather than the amelioration of the inflation problem given their inclusion in the base.

Leaving aside a few academics (namely Helliwell, Clark and Bossons) the Investment Dealers were the first to recognize publically the importance of the problem and to offer a "solution". Not surprisingly, the solution proposed, the "Canadian Investment Plan", focused exclusively on Canadian equities. (It must be acknowledged that the Investment Dealers did suggest other changes too.) The ISIP is the offspring of this proposal as modified in a major fashion first by the

Department of Finance in its Registered Shareholders Investment Plan (contained in the Discussion Paper issued 28 June, 1982) and then by the Lortie Committee (which reported 30 September, 1982).

The most notable features of the resulting ISIP, aside from the obvious indexing provision, are its restriction (for the most part) to listed securities purchased through the Plan, the partial accrual of taxable gains (25 percent annually) and the more generous treatment of losses. The Lortie Committee distinguished itself by rejecting the two extreme "solutions" - elimination of all gains from tax and the general indexation of the cost base of all assets. But it also rejected Finance's tentative "Indexed Term Deposit and Indexed Term Loan Plans". Aside from the $1000 interest income exception, the debt side of the capital market has not yet been dealt with in the tax system.

The principal reason for the rejection of the Indexed Term Deposits and Loans Proposal was the fear that the flows of funds in Canada would be seriously distorted as savings rushed to this new, attractive (although restricted) outlet and hence away from conventional uses with a consequent distortion of real investment expenditure. With the decline in the inflation rate to about 4 percent in the past two years, the concern for the inflationary component of capital gains has largely evaporated. There apparently has been no great rush to take up ISIPs, although the availability of more generous loss provision may gradually be more widely appreciated.

Several observations about what did and did not occur can be made from a public choice viewpoint.

1) Not surprisingly, the demand for provisions that at least partially ameliorated the problem arising for the capital gains and losses attributable to inflation came and went with the rise and fall of the inflation rate.

2) The voice of demand was restricted largely to the community of financial institutions and their organization.

3) The mass media, other than the business press, played virtually no role in the debate. The subject was too technical and the interests affected perceived to be too narrow to warrant mass media coverage.

4) As is generally the situation, highly technical tax structure issues afford appointed officials greater opportunities for exerting influence than "popular" tax issues. The decision to include in ISIP a partial (25 percent) accrual of capital gains was almost certainly the result of official pressures. This is not the kind of provision likely to be advanced by any special interest group. The same can be said for the rejection by the Lortie committee of the proposal that capital gains be excluded entirely from the tax base.

5) As a set of strategic manoeuvers the steps that preceded the introduction of the ISIP were an undoubted success. Having learned, presumably, from the fate of the November 1981

Budget fiasco, Finance did all the right things: concern was amply shown, Departmental ideas were set forth for comment in a Discussion Paper and an "independent", blue-ribbon committee of financial institution insiders was given the opportunity to hold hearings and make a public report. Aided of course by the fact that the intensity of the problem diminished, a partial "solution" was put in place that would be available if and when the problem recurred. The solution maintained the integrity of the comprehensive tax base, to use some not unbiased language. The reputation of the Minister of Finance, Marc Lalonde, was enhance, as was the stature of the Department. As an exercise in rancour dissipation there can be little doubt that the introduction of ISIP could well serve as a model. It demonstrates, perhaps, the political wisdom of doing as little as possible as late as possible with maximum consultation, affording officials ample opportunities in which to exert their informed influences. One wonders, for example, if an official did not suggest to at least some members of the Lortie Committee that, given the demise of death taxes to make way for the partial taxation of capital gains, would the removal of the latter raise again the need for the former - or even more horrifying - the need for a net worth tax?

## Case Study Number Six: Transformation of the Federal Manufacturers' Sales Tax Into a Sales Tax Levied at the Wholesale Level

Attempts to reform the federal manufacturers sales tax, like attempts to reform the real property tax in Ontario, have several features in common. First and foremost is the fact that the heavy reliance on both of these revenue sources has been highly politically expedient. If wealth should be taxed at all a real property tax is a most imperfect instrument. Similarly, if consumption should be taxed at all, a manufacturers' sales tax is not the instrument of choice from any point of view other than expediency. Secondly, in both cases the reform objective was to improve the structure while maintaining the same revenues. No attempt was made to soften the transition by reducing revenues at least temporarily or by grandfather provisions. Thirdly, the potential losers were already well informed and well organized while the potential winners were neither. Fourth, both attempts arose, perhaps, more from the pressure from pfficials, elected and/or appointed, then from some widely-based public complaint. Fifth, the mass media found both topics too complex, the consideration too protracted and the potential impacts too abstract and remote to be worthy of major attention.

The many weaknesses of the MST and the seemingly endless attempts to reform it have been described. It seems clear that there is virtually no support for the present MST system, some support for the imposition of the federal tax at the retail level

to be administered by the provinces in conjunction with their own retail taxes; no enthusiasm (with the exception of the automotive industry) for the imposition of the tax at the wholesale level, where some of the existing problems would be ameliorated but some new administrative/compliance costs incurred - not to mention the uncertainties and disruption of the transition.

The principal "villains" in the MST reform story seem not to be the organized lobbies, that played their usual roles, but rather elected officials - politicians. Federal politicians were anxious to avoid shifting the tax to the retail level for two reasons. The "hidden" MST would become exposed to public scrutiny and no doubt be perceived as a new, additional tax by many voters even if federal revenues remained the same. Federal politicians did not wish to incur the further enmity of provincial politicians that would be occasioned by a desirable change with well-nigh zero political benefits. Provincial politicians objected to the move to the retail level in part because, in the confusion, they, rather than the federal politicians, would be blamed; the stacking of the federal retail sales tax on top of existing provincial retail sales taxes would make further provincial sales tax increases even more politically costly. That, at least, ws the federal perception of the provincial perception.

In point of fact, the serious distortions created by the MST create resource allocation inefficiencies that probably result in heavy lost output costs. But they are indirect and diffused. They are seldom perceived by voters. The number of

organized special interests affected is large but their positions are countervailing. The whole topic is considered arcane and boring by most journalists, academics and tax practitioners.

Reform of the MST is therefore fraught with potentially heavy political costs with no likelihood of perceptible political benefits. In no field of taxation is the old adage clearer: the general interest is nobody's interest. In no field of taxation is the competition between the federal and provincial governments for net political benefits greater and less likely to bring about a desirable outcome. The "invisible hand" is, in this instance at least, working perversely.

Could a strong Federal Government not simply proceed in the face of intense provincial government opposition? Or could it not buy the Provinces off? The answers are in the affirmative but leave unanswered an even larger question: why use up political capital for a zero political return?

## Some Generalizations

The six Case Studies involve quite different kinds of proposed tax reforms that were put forward and fought over under quite different kinds of economic and political circumstances. Some, like the MST have a long history: others, like the partial indexation of the personal income tax, became prominent quickly and were quickly adopted, in relative terms. Some, like the treatment of bequests, are now quiescent but likely to reemerge; others, like the reform of the real property tax, are now dormant

and likely to remain that way if politicians have their way. Given the great diversity of the reforms and the limited analysis to which each of them has been subjected here, the following generalizations can only be advanced with warning flags flying.

1. Where the perceived political costs were high and/or the perceived political benefits were low, strong assertions by legitimately constituted authorities that particular taxes are significant sources of allocative inefficiency (i.e. the federal manufacturers' sales tax) or inequitable (i.e. the real property tax in Ontario) seemingly were enough to generate further protracted public enquiries but not enough to induce governments to adopt changes. Political arithmetic dominates other considerations, as one might expect in a system of "responsible" government. Presumably the immediate "fault" lies in the fact that the general or collective interest is not organized - except as The Government itself! (And the individuals that constitute The Government are not disinterested.) Perhaps the more fundamental problem, if such it be, is the lack of voter awareness of the issues and/or the little weight they assign to the resolution of general problems relative to specific problems that impinge, directly and immediately, on their own self interest. These findings come as no surprise but nevertheless are often negated by would be reformers who are inclined to assume that proclaiming something to the flawed is tantamount to removing the flaw.

2. The important role by organized interest groups, as emphasized by the theory of public choice, is affirmed. The

Investment Dealers of Canada, for example, played a lead role in determining the limited provisions that eventually emerged to deal with the inflationary component of capital gains. Perhaps more surprising is the failure of some latent groups to organize in pursuit of their interest. Real property owners in new subdivisions that bear a disproportionate share of the property tax assessment apparently did not lobby in an organized way. Nor did the local politicians who represent them, in so far as can be seen from an admittedly superficial examination of the public record. Shareholders apparently did not organize and lobby in favour of personal-corporate tax integration.

On the other hand, continuing organizations established for other purposes can be used, if needs be, for lobbying on tax issues that are seemingly of remote concern to them. An example would be the brief of the leather footwear manufacturers concerning the deliterious effects of death taxes. The personal tax positions by some of the principal owners of some of the member companies dominated the association's stand. Farm organizations and construction associations have been used for similar "personal" purposes. Similarly, executives of widely-held corporations have used the resources of the corporation to finance fights against full personal/corporate tax integration even though the interests of at least some of their shareholders probably called for a contrary stand. Executive hostility towards the taxation of fringe benefits, as well as a reluctance to see the removal of the bias against retained earnings, may well have been at the bottom of this apparently unseemly flight from the agency responsibilities of executives.

3. In two of the six case studies, the Ontario real property tax and the manufacturers' sales tax, the reformer's enemy was the elected politicians in another level of government. By definition, successful (elected) politicians, have a ready and an ongoing organization to support them in their battles against tax change. They are also in perpetual need of electoral and financial support. Hence they are ripe for capture by special interest groups. In the two instances just cited, however, the interest they were pursuing was largely their own. There was a great fear that an uninformed populace would place the blame on the wrong shoulders without any likelihood of capturing any political credit. Tax changes that yield major political costs that can not be shifted to opponents or dissipated by spreading them thinly are likely to be given short shrift by politicians. The latter are in an excellent position to do battle both for themselves. Because federal-provincial relations are in perpetual negotiation on one front or another, provincial opposition to a proposed federal tax change may manifest itself through provincial intransigence in some unrelated issue upon which the provinces have greater bargaining power. Logrolling and discrete extortion are not unknown phenomena.

4. A thorough media content analysis of the six tax reform proposals is, unfortunately, not available. One suspects, however, that the mass media paid scant attention to any of the proposals considered in the six cases examined. Virtually none too "technical" changes, like the tax treatment of the inflationary component of capital gains. Partly because of

the lack of expertise by mass media journalists and partly because of the presumed (probably correctly) lack of interest by readers and viewers, reform is a media non-event after the immediate announcement. One consequence is that the "debate", if such it can be called, is among a relatively small fraction of the electorate who are informed and organized and willing to invest in trying to affect the outcome. Political leaders are therefore placed in a position where it is politically efficient to "buy off" the few at the expense of the many. The "many" frequently are not aware that they are being adversely affected and/or are unable to do little other than cast a protest vote (that is unlikely to be decisive) at the next election. By giving weight to the interests of the silent majority, on the other hand, politicians in power run the risk of losing the financial support of organized interests, facing public opposition generated by propaganda financed by those interest and gaining not one iota of electoral support from those uninformed, unorganized voters' interests they purport to represent.

5. Strategic behaviour is one of the most important proposed considerations in tax reform. In pursuit of a perceived greater future benefit a smaller, more immediate benefit may be rejected. Thus, even though a change, such as full integration, may be judged to be to their immediate advantage, some taxpayers may reject it because they fear acceptance would pave the way for the taxation of capital gains - perceived to be a more substantial disadvantage. In the same vein, a constant revenue tax change that purported to make the tax base more equitable

might be rejected on the ground that with a fairer base politicians would be tempted to raise rates at some further date. So many promises have been broken in the past that statements made by politicians about tax change proposals are seldom taken at face value. Nor are they taken in isolation. Rather they are seen as skirmishes in a battle in an endless war where virtually anything goes. In this context, promises, because they are seldom if ever binding on successors, are a debased currency even when uttered by honest men.